DOCUMENT RESUME

ED 185 245 CE 023 968

AUTHOR	Bailard, Thomas E.: And Others
TITLE	Personal Money Management. Study Guide. Third Edition.
INSTITUTION	Science Research Associates, Inc., Chicago, Ill.
REPORT NO	SRA-13-2397
PUB DATE	80
NOTE	225p.: Some pages with small type will not reproduce well. For related documents see CE 023 967 and CE 023 969.
EDRS PRICE	MF01/PC09 Plus Postage.
DESCRIPTORS	*Banking: Behavioral Objectives: *Budgeting; Career Planning: *Consumer Education: Credit (Finance): Decision Making: Estate Planning; Housing; Income: *Insurance: Investment: Learning Activities: Long Range Planning: *Money Management: Postsecondary Education: Purchasing: Real Estate; Retirement; Study Guides: Taxes: Two Year Colleges

ABSTRACT

This guide is designed to accompany the text, Personal Money Management (CE 023 967), and the companion instructor's guide (CE 023 969). It is intended as an aid to understanding the materials read in the text and to applying the concepts and ideas to the student's own financial circumstances. Each chapter contains these sections: performance objectives, outline of the main ideas, self-testing exercises, and personal money management activities. Additional activities and blank worksheets are provided with certain chapters as appropriate. Answers to the exercises are found at the end of the guide. (YLB)

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Study Guide

PERSONAL MONEY MANAGEMENT

THIRD EDITION

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Printed in the United States of America.

ISBN 0-574-19397-9

10 9 8 7 6 5 4 3 2 1

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Preface

This guide is designed to help you understand the material you have read in *Personal Money Management* and to apply the concepts and ideas to your own financial circumstances. The ability to manage your money effectively will be a rewarding skill for the rest of your life.

Each *Study Guide* chapter contains the following sections: performance objectives, outline of the main ideas, self-testing exercises, and personal money management activities; additional activities and blank worksheets are also provided with certain chapters as appropriate. Answers to the exercises will be found at the end of this guide.

- *Performance objectives* indicate what you should be able to accomplish once you have mastered the material in the chapter.
- *Outline of the main ideas* summarizes the text chapter content in sequence and can be used to review the information, perhaps in preparation for a class discussion or a test. As you read each outline entry, recall the material being summarized. If you don't have a clear recollection of it, go back to the text and read the appropriate section again.
- *Self-testing exercises* are designed to help you check whether you have learned the main points of each chapter. They consist of true-false, completion, and multiple-choice questions—largely recall questions, although some require mathematical computations or logical deductions from the text material—and problems and cases. The latter give you a chance to work with the concepts presented in the text. Some problems and cases are fairly easy, if you've understood the chapter material; others are quite involved, reflecting the complexities of real life, and might take you 15 to 30 minutes to solve. Also, in those chapters where there is a form for implementing a step-by-step numerical procedure, there are case problems in this guide to give you practice using these tools.
- *Personal money management activities* highlight what you should do to apply the chapter ideas to your own situation. This is where the course will pay off in real dollars for you.
- *Additional activities* can help you understand the material and better acquaint you with the legal documents (e.g., insurance policy, rental contract) and the people (e.g., agents, brokers) and firms you must deal with in each area of personal finance.
- *Answers to the exercises* (provided at the end of this guide) enable you to check your comprehension of the material covered in the self-testing exercises. To make sure you really learn and remember the

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material, you should not look at the answers until after you have worked through the exercises. This trial and error method helps you distinguish what you know from what you don't know so that you can direct your studying toward filling in the gaps.

- *Blank forms* of the worksheets used in the text examples are provided in appropriate chapters. You may want to make several copies before writing on them so that you can use them throughout your life as the need arises.

Enjoy your study of personal money management!

1 · Introduction

PERFORMANCE OBJECTIVES

After studying this chapter, you should be able to:

- Look for how your emotions and values are reflected in your financial decisions.
- Describe the interrelationships between goals, personal assets, and financial resources.
- Explain the importance of money management.
- Express your financial goals. (The order in which you will pursue them may change as you read the text.)
- List and explain the three strategies of money management.
- List and explain the functions of a money manager.
- Discuss the difference between inflation and deflation.
- Discuss the causes of inflation and the difficulty in projecting future inflationary rates.

OUTLINE OF THE MAIN IDEAS

I. As a mean of exchange for goods and services, money is an important commodity in our lives. You should be able not only to earn it, but also to manage it effectively.

II. At least three forces affect how you use your money.
    A. *Emotions* that predominate in money matters are fear and greed.
        1. Fear of creating a bad image, of being controlled by others, of losing financial security
        2. Greed as inordinate grasping, especially for wealth or gain
    B. *Values,* our cherished attitudes toward life, may be internally or externally derived; their effect on financial choices is not constant.
    C. *Advertising* attempts to influence our financial choices by playing on our emotions and values.
    D. Knowing your own emotions and values is very important if you want to make sound financial decisions throughout your life.

III. Financial resources can be used, along with personal assets, to achieve one's goals.
  - A. Goals are aims or purposes people set for achievement for themselves and their families. Some goals are best achieved by use of personal efforts, some by use of financial resources, others by both.
  - B. Personal assets, which include natural talents and abilities plus skills and knowledge, can be used to achieve personal goals, financial or otherwise.
  - C. Financial resources, which include both income and assets, can also be used to achieve personal goals.

IV. The process of money management seeks to achieve goals best satisfied with money.
  - A. The process begins with the establishment of financial goals: what each goal is, when you want to reach it, and how much it will cost.
  - B. There are essentially three strategies of money management: protecting what you have, getting the most out of your income, and increasing your total income.

V. The money manager plans and forecasts goals, directs the efforts of others as they are involved in achieving the goals, and controls the course of financial efforts so that resources are always being deployed toward the most appropriate goals.

VI. Inflation and, to a much lesser extent, deflation are conditions the money manager must cope with almost constantly.
  - A. Inflation produces a rise in the price level; it takes more and more money to buy the same good or service. Deflation, a reduction in volume of purchasing power, causes less and less money to be used to buy goods and services.
    1. Increased cost for a good or service that reflects an improvement is not inflation.
    2. Producing a good or delivering a service more efficiently can reduce the cost of this item, but this is not deflation.
  - B. The causes of inflation are numerous and have a different impact under different economic and social conditions.
    1. Inflation can result from having too much money in circulation relative to the level of economic activity.
    2. Federal government spending that overstimulates the economy can cause inflation.
    3. Inflation can be caused by powerful industries or labor unions dictating what prices or wages will be.
    4. Inflation can be caused by shortages in goods.
    5. Deterioration in the value of our currency relative to other currencies can cause inflation.
  - C. A money manager must decide how the value of money will change in the future and at what rate.
  - D. The federal government attempts to measure the rate of inflation with the consumer price index.

VII. The text is organized into five units: "Getting Started" (Chapters 1-4); "Protecting What You Have" (Chapters 5-9); "Getting the Most Out of Your Income" (Chapters 10-14); "Increasing Your Income" (Chapters 15-20); and "Planning for Retirement and Estate Transfer" (Chapters 21-22).

SELF-TESTING EXERCISES

True-False

_____ 1. One may manage money well even though one has no definite goals.

_____ 2. Even persons with above-average incomes can get into financial difficulty.

_____ 3. Most people spend as much time learning how to acquire money (through their careers) as learning how to manage it.

_____ 4. Money is not an end in itself but a means to obtain financial goals.

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_____ 5. Most people are not influenced by their emotions when making monetary decisions.

_____ 6. The three major forces that affect a person's spending are fear, greed, and advertising.

_____ 7. Any increase in the price of a product can be assumed to be due to inflation.

_____ 8. Inflation causes a decline in the purchasing power of money.

_____ 9. To meet financial emergencies, money spenders tend to rely on borrowing money.

_____ 10. A primary objective of money management is the achievement of goals that demand money.

Completion

1. Our use of money is influenced by ______________________, ______________________, and ______________________.
2. The two dominant emotions in monetary decisions are ______________________ and ______________________.
3. Value judgments arise from influences that can be classified as ______________________, ______________________, and ______________________.
4. Both ______________________ and ______________________ assets may be used to increase financial assets.
5. One popular measure of inflation is the ______________________.

Multiple Choice

1. Which of the following is the primary function of a money manager?
   - a. Planning
   - b. Directing
   - c. Controlling
   - d. Dictating
   - e. Earning
2. Which of the following is NOT a cause of inflation?
   - a. Federal spending
   - b. Improvements in products
   - c. Shortages of goods
   - d. Too much money in circulation
   - e. Wage increases dictated by unions
3. The price of football tickets increased from $5.00 to $6.50 in one year. What was the percentage increase in the price?
   - a. 10%
   - b. 20%
   - c. 30%
   - d. 35%
   - e. 40%
4. Which of the following is the main effect of inflation?
   - a. Lower interest rates
   - b. Unemployment
   - c. Decline in purchasing power
   - d. Oil crises
   - e. Reduced income taxes
5. In their control function, money managers need to look out for changes especially in
   - a. their checking account balance
   - b. the stock market
   - c. the performance of the professionals they hire
   - d. the consumer price index
   - e. their financial goals

Cases and Problems

1. Maria wants to buy a handbag. She can buy a leather one by a name designer for $85, a leather one at a nationwide retail store for $50, or a vinyl one at a discount store for $18. Analyze the factors that might lead her to decide which one to buy.

2. Tom and Carmen have the following financial goals. Arrange them using the form below.

   a. A new car two years from now costing $6,800
   b. A vacation this summer costing $750
   c. A college education for Tom, Jr., beginning eight years from now at a present cost of $5,000 a year for four years
   d. Down payment and closing costs for a new home four years from now costing $5,500
   e. Music lessons for Carmen at $500 a year for the next two years.

Year Goal	1	2	3	4	5	6	7	8
Total								

3. Elton is 45 years old, and has a wife and five children. As a manager with a nationally known life insurance company, he makes $35,000 a year before taxes. His home has a market value of $100,000. Elton cannot meet his debt payments.

   a. How might he have gotten into this situation?
   b. How might a course in money management have helped him avoid this situation?

PERSONAL MONEY MANAGEMENT ACTIVITIES

1. Analyze a recent financial decision you have made in terms of the motivation behind it.

2. Use the following form to outline your own goals.

Year Goal	1	2	3	4	5	6	7	8
Total								

3. Indicate broadly the strategies (methods) you might use to achieve the above goals.

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2 · Your Career and Income

PERFORMANCE OBJECTIVES

After studying this chapter, you should be able to:

- Describe some of the basic causes for differences in incomes—type of work, education, experience, geography, discrimination, luck, ability, and drive.
- Make a preliminary determination of your important career objectives—income, status, career in relation to personal life, use of personal abilities, security, personal growth.
- Select careers that fit your personal objectives.
- Locate jobs within your career choices.
- Describe the basic procedures involved in job search, résumé writing, and interviewing.

OUTLINE OF THE MAIN IDEAS

I. Most people earn the money they manage; earning enough to provide a comfortable living should not be taken for granted.

II. Several factors affect how much a person earns.
   A. Some types of work are more vulnerable to variations in supply and demand than others; higher-paying jobs tend to require specialized skills that are needed by society but that relatively few people have.
   B. The more education one has, the more one is likely to earn (Table 2-2).
   C. One's earnings tend to increase with experience, at least until about age 54 (Fig. 2-3).
   D. Incomes and expenses vary regionally. One may earn more, and need to earn more, in the North Central states than in the South.
   E. Discrimination—based on race, sex, religion, or age—affects income level.
   F. A family heritage of high earnings does not guarantee continued wealth, nor does a family heritage of low earnings make continued poverty inevitable.
   G. Luck seems to come to those who have the ability and drive to seize the opportunity when it comes.

III. Selecting a career requires long-term planning.

A. The first step is getting to know yourself.

1. Use available literature, and take aptitude and interest tests.
2. Research and review your past experiences and satisfactions.
3. Consider how your job will relate to the rest of your life.
4. Look at your abilities, preferences, and needs.
5. A job can provide opportunities for personal growth.
6. Be prepared to make compromises about what you want in a job.

B. The second step is to know the alternatives.

1. Consider the advantages and disadvantages of government vs. the private sector, of a large firm vs. a small firm, and of owning your own business.
2. Make a decision, but don't be afraid to change it once you have more experience. Mid-life career changes can be the most satisfying.

IV. Finding and landing the job involves marketing yourself.

A. You can learn about available jobs through counselors at the college placement office, job recruiters, want ads, and state and private employment agencies; letting your availability be known through personal visits to likely companies or through family, friends, professors, and business contacts may lead to the job you are looking for.

B. Make a good first impression through your résumé and cover letter.

1. The résumé outlines in one or two pages your education, experience, and job qualifications; it is directed toward the job you are seeking and aims to make the reader want to interview you for the job.
2. The cover letter should be brief, personalized, yet businesslike; it states the job you seek and why you want it with this particular company, as well as your availability for an interview and to begin the job if offered.

C. At the first interview be pleasant, be yourself, dress appropriately; be prepared to answer questions, but defer detailed questions about the job and salary. Send a followup thank-you letter.

D. At the second interview you may be introduced to potential associates and supervisors; ask the questions you need to know.

E. If the job is offered and you are uncertain, request another interview at your expense. Send thank-you letters to other interviewers informing them you took another position.

SELF-TESTING EXERCISES

True-False

_____ 1. Thirty percent of U.S. families have inadequate incomes.

_____ 2. The outlook regarding future demand for certain jobs should not influence one's career choices.

_____ 3. Career choices have little effect on personal happiness.

_____ 4. Statistics show a direct correlation between education and lifetime income.

_____ 5. Median family income of blacks and other races as a percentage of median income of whites has decreased from 60.6 percent in 1947 to 55.3 percent in 1977.

_____ 6. Once you have successfully entered a career, you need never make such a decision again.

_____ 7. Up to a point, a person's earnings tend to increase over time.

_____ 8. Employers tend to value on-the-job experience in their employees.

_____ 9. The first step in the career selection process is to know oneself.

_____ 10. In choosing one's career, personal fulfillment and personal values are as important as income.

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Completion

1. The ________________ education one has, the more one is likely to earn.
2. Statistics show that ________________ have the highest unemployment rate.
3. The first step in the career selection process is to ________________.
4. The first impression you make on a potential employer will most likely be from your ________________ and ________________.
5. A one- or two-page outline of your education, experience, and job qualifications is called a ________________.

Multiple Choice

1. According to government statistics, costs of the higher standard of living ranged from about $22,000 in Austin, Texas, to about how much in New York City?

   a. $18,000
   b. $28,000
   c. $32,000
   d. $40,000
   e. $45,000

2. According to the table of annual income for selected occupations in 1976, the highest starting salary was paid to

   a. bank officers, M.B.A.
   b. engineers, M.S.
   c. engineers, Ph.D.
   d. physicists, Ph.D.
   e. lawyers

3. In 1976, in the United States approximately ________________ percent of women over age 15 were in the labor force.

   a. 40
   b. 50
   c. 60
   d. 70
   e. 80

4. Differences in income are due to

   a. type of work
   b. age and experience
   c. amount of education
   d. differences in family heritage
   e. (All of the above)

5. In 1977 full-time female workers in the United States were paid about ________________ percent as much as full-time male workers.

   a. 40
   b. 50
   c. 60
   d. 70
   e. 80

6. Economic studies have shown that

   a. there's no economic value to getting a college degree
   b. high-income families easily maintain their same financial position generation after generation
   c. it's impossible to get ahead in the economic system we have today
   d. lower-income groups can, over time, narrow the income difference between them and higher-income groups

Cases and Problems

1. Jerry has completed his first year at State College. He likes geology but did equally well in economics. He is not yet sure what career he wants to pursue.
   a. Should Jerry defer his decision or make it now?
   b. What kind of courses should he take now?
   c. What can Jerry do to help him make career plans?
2. Carl and Dana have been married 10 years and have two children, ages 9 and 7. Carl works for a nationwide CPA firm; he received his CPA certificate two years ago. Dana is an editor in a large publishing firm and is paid $18,000 a year, $5,000 less than Carl. Their home is appraised at $60,000 and their mortgage is $15,000.
   a. Could either Carl or Dana change careers now?
   b. If Carl were offered a job in another area at an increase of $7,000 in salary, should he accept the offer even though Dana would have to give up her present position? Give the pros and cons.

PERSONAL MONEY MANAGEMENT ACTIVITIES

1. Using the model in your text, make up your own résumé and cover letter to a firm in which you would like to be employed.
2. Outline the main differences between the first and second interviews.

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3 · Your Financial Starting Point

PERFORMANCE OBJECTIVES

After studying this chapter, you should be able to:

- Establish a personal or family record-keeping system that contains the information necessary for making important financial decisions.
- Construct your own personal income statement.
- Construct your own personal balance sheet.
- Explain the use of the income statement and balance sheet in planning, directing, and controlling a family's financial affairs.

OUTLINE OF THE MAIN IDEAS

I. Records are necessary for financial planning and control.
    A. Keep your records in a series of manila folders in a single box or file cabinet.
    B. Make different kinds of files, noting the contents of each and appending an operational checklist.
        1. General (including your personal information sheet)
        2. Budgeting
        3. Housing
        4. Insurance by type
        5. Investments by type
        6. Taxes
        7. Guarantees and warranties
        8. Employment information
        9. Personal résumé
        10. Credit records
    C. Update the contents of each file periodically and weed out the obsolete.
    D. Keep important and perishable documents in a safe-deposit box or in an attorney's or broker's office.

II. Knowing where you stand financially is very difficult unless you prepare an income statement and a balance sheet.
  A. An income statement summarizes your past income and expenses over a specific time period, usually a year; the amount left over is your net income or net loss.
    1. Compare your income statement with typical expenditure patterns for an urban family of four (Tables 3-2 and 3-3). Lower-income groups tend to rent, use mass transit, and spend proportionately less on discretionary items and proportionately more on food.
    2. Evaluate how you are spending your money, especially whether the fixed expenditures are excessive.
    3. Because the income statement reports past expenses, it can be used to make a budget for future expenses.
  B. The balance sheet summarizes your assets (resources), and liabilities (debts) as of a specific day; the difference between them is your net worth.
    1. Evaluate your assets and liabilities, including whether your monetary assets are 30 to 50 percent of your net worth, whether more than 20 percent of your net worth is in any one asset other than your home, and whether your non-mortgage loans total more than 50 percent of your non-real estate assets.
  C. The income statement affects the balance sheet in that net income increases net worth and net loss decreases net worth.

III. Financial statements are used in various ways, including preparing a budget, applying for a loan, preparing tax returns, determining insurance needs, and measuring financial progress.
  A. An example of an executive who overextended himself shows what can happen when one ignores one's income statement and balance sheet.

SELF-TESTING EXERCISES

True-False

_____ 1. Medical expenses are about the same amount for both higher- and lower-income groups.

_____ 2. The amount spent on discretionary items rises rapidly as incomes decrease.

_____ 3. Higher-income groups tend to own their own housing, while lower-income groups tend to rent.

_____ 4. The percentage of the total budget used for food increases directly with income.

_____ 5. Since the income statement reports expenses, it can be used to prepare a budget.

_____ 6. Checkbook stubs and receipts are all that is needed for efficient record keeping.

_____ 7. Your income statement shows whether your income exceeded your expenses, or vice versa, over a given time period.

_____ 8. The financial statement that reports one's assets, liabilities, and net worth is called a balance sheet.

_____ 9. If your non-mortgage debts are more than 20 percent of your non-real estate assets, you need to reduce this kind of debt.

_____ 10. A profit on your income statement results in an increased net worth on your balance sheet.

Completion

1. The location of important documents such as wills and deeds is stated on the ____________________ ____________________ sheet.

2. Important and easily destroyed documents should be kept in a ____________________.

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3. Your financial net worth is shown in the statement called the ______________________________

______________________.

4. If your expenses exceed your income over a period of time, your income statement will show a ________

____.

5. Amounts owed to creditors appear in the ______________________ section of your balance sheet.

6. The sum of your net worth and liabilities is exactly equal to your ______________________.

7. Monthly payments made on your car will appear on your ______________________________

______________________.

8. The difference between your assets and liabilities is called your ______________________________

______________________.

9. Net income (increases, decreases) ______________________ net worth.

10. Your ______________________ assets constitute your emergency fund.

Multiple Choice

1. Your income statement shows your

a. liabilities and income
b. past expenses and income
c. future expenses and income
d. assets and liabilities
e. net worth

2. Your balance sheet shows your

a. liabilities and income
b. assets and expenses
c. income and expenses
d. net worth
e. (None of the above)

3. Jeff earned $8,000 last year. He has $50 in cash, $300 in savings, and a car with a Blue Book value of $3,500. He owes $2,500 on his car. His net worth is

a. $9,350
b. $8,350
c. $3,850
d. $1,350
e. $350

4. A record-keeping system will directly help you do any of the following EXCEPT

a. choose a good insurance agent
b. prepare your tax return
c. fill out a credit application
d. prepare a budget

5. Jeff earned $8,000 last year. His taxes were $900 and his living expenses were $6,100. His investments, worth $10,000, returned him $500 in interest and dividends. His net income (loss) was

a. ($1,000)
b. $1,000
c. $1,200
d. $1,500
e. $8,500

6. You could use your income statement to

a. see where you spent your money last year
b. plan your income expenses for next year
c. compare the fixed and variable portion of each expense category
d. decide whether you can take on a new series of installment loan payments
e. (Any of the above)

7. To construct your balance sheet, you would need your
   a. checkbook, savings passbook, last year's tax return
   b. W-2 form, savings passbook, last year's tax return
   c. checkbook, savings passbook, list of unpaid bills
   d. W-2 form, paycheck stub, insurance policies

Cases and Problems

1. Together the Morenos earned $30,000 in 1979. Their total taxes were $7,000. Their living expenses were as follows:

food and personal	$6,000
housing	$6,500
medical and dental	$900
clothing	$3,000
transportation	$3,200
miscellaneous	$2,800

   a. Prepare an income statement for the Morenos.

   b. Do the Morenos have any savings after expenses?

   c. What do you think the Morenos used as the sources of the information about their income, taxes, and expenses?

2. The Morenos have $900 in their checking account and $1,500 in their savings account. The cash value of their life insurance policy is $2,000. Their stock and bond investments (lower of cost or market) are worth $7,000. Their home is appraised at $75,000 and their mortgage debt on it is now $35,000. Blue Book low values on their two cars are $2,500 and $1,200. Their personal belongings after depreciation are worth about $4,500. They owe $700 in bills outstanding and $2,500 in installment debt.

   a. Prepare a balance sheet for the Morenos as of this date.

   b. What is their net worth?

   c. Do the Morenos seem financially sound?

3. Trina was going over her financial affairs one early January and decided she ought to make some sense of the items she had strewn about the desk top. Among them were the following:

   - Balance in checkbook of $345
   - Group life insurance coverage provided by her employer of $10,000 with no cash surrender value
   - Four monthly payments of $130 each remaining on auto loan
   - W-2 form showing she earned $12,000 last year, paid $702 in Social Security taxes, had $1,805 withheld in federal income taxes, and $125 in state income taxes. (She usually came out close to even on her withholding when it came time to file her return each year, since she figured out in advance how much to have withheld.)
   - Receipt stub from last month's semiannual auto insurance premium of $120
   - Savings account balance of $2,108, which included $108 of interest she received last year
   - Used car ads showing her car is worth about $2,100

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- Checkbook entries for the past year totaling as follows:

Rent	$2,520
Utilities	416
Unidentified cash	320
Property insurance	120
Grocery store	1,100 (including personal items)
New stereo set	690
Clothing	620
Gas and auto repairs	640
Auto license	50
Recreation	360
Vacation trip	460
Dentist	86

- Latest payroll stub showing she pays $10 a month toward the cost of her group health insurance program
- Property insurance policy for the contents of her apartment estimated by Trina to be worth about $8,000
- The following unpaid bills:

Bank charge card	$246
Telephone	14

- A certificate for 10 shares of AT&T common stock given Trina by her grandmother, with a market price of $65 per share in today's paper. (Trina received cash dividends of $3.80 per share during the past year from this stock.)
- Cash in her wallet: $27
- An I.O.U. from Sally, whom she hadn't seen or heard from since she moved to Alaska two and one-half years ago: $80

a. Construct Trina's income statement. What "profit" or "loss" did she have last year?

b. If she continues this year about as she has in the past year, will her profit or loss be unchanged, better, or worse, and by about how much, if any?

c. If Trina had a need or desire to save more money, what are some ideas you might give her?

d. What is her net worth?

e. Construct Trina's balance sheet. What percentage of it is liquid (easily sold or converted to cash)?

f. Has she allowed her debts to get out of control?

PERSONAL MONEY MANAGEMENT EXERCISES

1. Set up your personal financial filing system using the labels shown beginning on page 14.
2. Complete a copy of the personal information sheet for your file system.
3. Prepare your personal income statement and balance sheet using copies of the blank forms at the end of this chapter.

4. Use the form provided on page 20 to help you organize your decision making by month and see in advance the appropriate time for making a given financial decision. To fill out the calendar, determine when financial decisions or events will be required for each of the categories listed across the top. Then describe the decision to be made or action to be taken in the box that marks the intersection of the category column with the row for the appropriate month. For example, if you have an auto insurance premium due in May, write "review coverage and pay premium" under the auto insurance column in the row marked May.

ADDITIONAL ACTIVITIES

More and more public officials are being required to make public their balance sheet details; some choose to do it because of political advantage. If you can, look up such a published financial statement or keep these questions in mind the next time you see one.

1. Does it appear that all of the likely categories are included in the report?
2. Which dollar values are readily determined?
3. Which dollar figures are probably the result of an "educated guess"? Might there be a reason to bias them one way or another?
4. How would you (or your parents) feel about disclosing your (their) balance sheet to the public?
5. President Carter sold his peanut industry holdings to avoid any potential conflicts of interest in his role as President. Should all officials be required to do this? Might the mere disclosure of potential conflicts be sufficient to curb any tendency toward self-serving acts?
6. Since the United States is generally capitalistic, should the President be required to purchase one share of stock in every publicly available corporation (via a loan from the U.S. Treasury) in order to provide personal incentive to see that the economy does well?
7. Should the President sell *all* his assets and put his cash in a government vault to avoid *any* potential conflicts of interest (and make him work harder to avoid inflation, which would reduce the value of his cash)?

Contents and Operational Checklist for Each File of Financial Records

Heading	*Contents*	*Operational Checklist*
General	Personal information sheet (Fig. 3-1) List of items in safe-deposit box Letter of last instructions (Chapter 22) Copy of will (Chapter 22) [The original should be kept with attorney or in a safe-deposit box.]	Update personal information sheet to reflect any changes. Update safe-deposit box list as new items are added or old ones eliminated.
Budgeting	Lists of goals Income statement (Chapter 3) Forecasts of income and expenses (Chapter 4) Forecasts for short-term and long-term goals (Chapter 4) Old budget control sheets (Chapter 4)	Review budget planning sheets. Revise goals, if necessary.

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Heading	*Contents*	*Operational Checklist*
Housing	Purchase contract and receipt [deed in safe-deposit box] Mortgage papers Title insurance policy Home improvement receipts (including landscaping expenses) Property tax receipts Termite inspection and policy Copy of lease or rental agreement	Keep records of all permanent home improvements so that you can establish an accurate cost basis if you ever sell your home.
Property Insurance	Details of property insurance coverage [Insurance policies or a data sheet in a safe-deposit box.] Personal property inventory (Chapter 6) [copy in safe-deposit box] Pictures of highly valued items [negatives in safe-deposit box]	Change insurance limits on policy annually to reflect changes in personal property holdings and/or changes in replacement costs of all structures. Update personal property inventory once a year: add new items; revalue old items; eliminate items sold or lost; take more pictures, if necessary. Shop for rates. Get a minimum of three quotes before each renewal date.
Investments—Mutual Funds	Records of purchase and sale of mutual funds [Keep mutual fund shares with broker, with the mutual fund transfer agent, or in safe-deposit box.]	Use transaction slips and statements to update records of purchases, sales. Place each year's transaction slips and monthly statements in an envelope.
Tax	Purchase receipts, interest payment records, charitable gift confirmations, medical expense records, and so on. Tax forms, schedules, and supporting data for past 10 years Quarterly estimated tax forms W-2 forms, 1099 forms, and so on All canceled checks for last seven years	File all receipts required to substantiate deductions. After your annual tax form is filed, place all receipts and other substantiating records in an envelope and file either here or in extra storage boxes.
Guarantees and Warranties	All warranties relating to appliances, tires, carpets, and the like. Receipts Repair instructions	Add items to file as soon as purchased. Remove once each year all that have expired.
Employment Information	Employment contract, if any Employee handbook Fringe benefits information	Update file as necessary.
Personal Résumé	Details of previous education: years, major, degree(s), major professors and advisors (with address, phone number) Employment record: job titles, dates responsibilities, supervisors' names and addresses Residence record: dates and addresses	When you switch jobs, put information from employment file in here. Before you leave a school, update file with addresses you may need.

Heading	*Contents*	*Operational Checklist*
Credit Records	Papers showing resolution of prior debts Credit card numbers, names, and addresses Notification forms for lost or stolen cards	Update file as necessary.
Auto Insurance	Details of auto insurance coverage Record of traffic violations and accidents Auto registration receipts [ownership certificate in safe-deposit box]	Update fact sheet annually by adding new cars, amending coverages, and raising drivers' ages Update traffic violation and accident records. Note which violations or accidents occurred over three years ago and stop including them in insurance applications. Shop for rates. Get a minimum of three quotes before each renewal date.
Health Insurance	Insurance policies or details of present health coverage, including employee plans Current medical history for each family member List of drugs to which each family member is allergic	Update health insurance fact sheet to reflect changes in limits, coverage, and so on. Update medical histories to reflect new ailments, diseases, and immunizations received.
Life Insurance	Details of insurance policies owned, including employee group plans [insurance policies or a data sheet in safe-deposit box] Results of eight-step procedure (Chapter 9) for determining life insurance needs	Recompute insurance needs using eight-step procedure every five years—sooner if new financial assets are acquired, or if family income or expenses change significantly. Update life insurance fact sheet to reflect changes in needs and beneficiaries, and coverage increases in employee policies. Shop for at least three rate quotes before each change in policy. Review the need for beneficiary changes.
Investments—General	Goal planning sheet (11-step procedure, Chapter 15) Annual balance sheets (Chapter 3) List of checking/savings accounts	Replan goals using 11-step procedure. Plot your progress using annual balance sheet.
Investments—Stocks and Bonds	Records of purchase and sale [All stock certificates and bonds should be kept either with broker or in safe-deposit box.] Records of stock dividends and bond interest List of stock certificate numbers and dates of issue (if you keep certificates in safe-deposit box rather than with broker) Transaction slips and monthly statements (annual envelopes)	Update records to reflect purchases and sales evidenced by transaction slips. Add new stock numbers and dates of issue to list (if certificates are sent to you). Place each year's transaction and monthly statements in an envelope.

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NAME(S) ____________________

DATE ____________________

Social Security No. ______________ Military I.D. No. ______________

PERSONAL INFORMATION SHEET

	ACCOUNT NUMBER	INSTITUTION NAME
Checking accounts		
Savings accounts		
Safe-deposit box (Location of keys)		
Brokerage account		

Location of stock certificates ____________________

Location of deeds ____________________

Location of other securities ____________________

Location of will ____________________

Executor's name ______________ Phone ______________

Address ____________________

Attorney's name ______________ Phone ______________

Address ____________________

Broker's name ______________ Phone ______________

Address ____________________

Accountant's name ______________ Phone ______________

Address ____________________

Insurance agent's name ______________ Phone ______________

Address ____________________

( ) name ______________ Phone ______________

Address ____________________

NAME(S) ______________________________

FOR THE YEAR BEGINNING JAN. 1, ______ AND ENDING DEC. 31, ______

INCOME STATEMENT

1 *Income*			
Wages or salary			
Husband	______		
Wife	______		
Dividends and interest	______		
Capital gains and losses (e.g., from sale of stock)	______		
Rents, annuities, pensions, and such	______		
Other ______________________	______		
2 *TOTAL INCOME*			______
3 *Taxes*			
Personal income taxes	______		
Social Security and disability taxes	______		
4 *TOTAL TAXES*			______
5 *Amount Remaining for Living Expenses and Investment*			______
6 *Living Expenses*	*Fixed*	*Variable*	
Housing			
Utilities	______	______	
Repairs	______	______	
Insurance	______	______	
Taxes	______	______	
Rent or mortgage payments	______	______	
Other ______________________			
Food	______	______	
Clothing (including laundry, dry cleaning, repair, and personal effects)	______	______	
Transportation			
Gas	______	______	
Repairs	______	______	
Licenses	______	______	
Insurance	______	______	
Auto payments or purchase	______	______	
Recreation, entertainment, and vacations	______	______	
Medical			
Doctor	______	______	
Dentist	______	______	
Medicines	______	______	
Insurance	______	______	
Personal	______	______	
Life insurance	______	______	
Outlays for fixed assets	______	______	
Other expenses ______________________	______	______	
SUBTOTAL	______	______	
7 *TOTAL ANNUAL LIVING EXPENSES*			______
8 *Amount Remaining for Savings and Investment*			______

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NAME(S) ______________________________

DATE ______________________________

BALANCE SHEET

ASSETS

MONETARY ASSETS

1 *Cash*
  On hand ______
  Checking account ______
  Savings account ______
  TOTAL CASH ______

2 *Money loaned to others*
  (repayment expected) ______

3 *Investments*
  Savings bonds ______
  Stocks and bonds ______
  Mutual funds ______
  Cash value of life insurance ______
  Cash value of annuities ______
  Cash value of retirement fund ______
  TOTAL INVESTMENTS ______

4 *TOTAL MONETARY ASSETS* ______

FIXED ASSETS

5 *Home and property* ______

6 *Investments*
  Other real estate ______
  Retirement fund ______

7 *Automobiles* ______

8 *Ownership interests in small businesses* ______

9 *Personal property* ______

10 *TOTAL FIXED ASSETS* ______

11 *TOTAL ASSETS OF FAMILY* ______

LIABILITIES

12 *Unpaid Bills*
  Taxes ______
  Insurance premiums ______
  Rent ______
  Utilities ______
  Charge accounts ______
  Other ______________ ______
  TOTAL UNPAID BILLS ______

13 *Installment Loans* (balance due)
  Automobile ______
  Other ______________ ______
  TOTAL ______

14 *Loans* (balance)
  Bank ______
  Education ______
  Other ______________ ______
  TOTAL ______

15 *Mortgage Loans* (balance due)
  Home ______
  Other ______________ ______
  TOTAL ______

16 *TOTAL LIABILITIES* ______

17 *NET WORTH* ______

18 *LIABILITIES AND NET WORTH* ______

TIMETABLE FOR FINANCIAL DECISIONS

Month	Insurance				Budgeting	Tax	Housing	Investments		
	Property	Auto	Health	Life				General	Stocks and Bonds	Mutual Funds
January										
February										
March										
April										
May										
June										
July										
August										
September										
October										
November										
December										

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4 · Budgeting

PERFORMANCE OBJECTIVES

After studying this chapter, you should be able to:

- Record your expenses effectively.
- Forecast your income and expenses.
- Set up a budget that controls expenditures but has flexibility.
- Plan expenditures in a way that removes guilt from spending and avoids family disputes.
- Plan expenditures so that there will be savings for meeting future expenses and achieving goals.

OUTLINE OF THE MAIN IDEAS

I. A budget is a plan to allocate one's income efficiently to all the categories needed to maintain one's lifestyle.
  A. You know you need a budget if you are getting behind in payments, have little or no savings, run out of money before your next paycheck, or have to borrow to buy an item you need.
  B. A budget can help you save (and thus avoid having to borrow), live within your income, resolve family financial arguments, and keep a record of expenses that qualify as income tax deductions.
  C. Avoid dictatorial budgets (example of Phil and Ellie); they are self-defeating.

II. Developing a workable budget requires careful planning.
  A. Keep in mind the dual objectives of budgeting:
    1. To bring your spending under greater control.
    2. To reduce money wasted in each expense category.
  B. Step 1 is to become aware of your spending patterns by reviewing your income statement and keeping detailed records of expenses for about a month.

C. Step 2 is to involve the family in deciding on financial goals and priorities.
   1. Prepare for family planning meeting by forecasting your income (both as monthly average and as annual total) for the coming year (Fig. 4-1) and deciding on appropriate expense categories (Fig. 4-2).
      a. Keep similar expenses in the same category.
      b. Have enough categories for a meaningful record.
      c. Keep the number of categories small enough for easy bookkeeping (but be sure to allow for savings and mad money).
   2. Be aware of how some common emotional problems can make this planning session (and budgeting in general) difficult: spending for status, use of money to control, retaliatory spending, first claim to money earned, and lack of self-esteem.
   3. Hold family meeting to inform them, uncritically, of present spending patterns and work out short-term goals (Fig. 4-3) and long-term goals (Fig. 4-4).
   4. Divide the cost of each goal that can be reached within five years by the number of months you have to reach it and place this amount in your savings and investment category.
   5. Forecast expenses first for fixed payments (such as for housing) and then for the remaining categories (Fig. 4-5).
      a. Total each expense category and divide by 12 to get monthly allowable limits.
      b. If your estimated expenses are greater than estimated income, the family must set priorities.

III. Make the recording of expenses a simple task.
   A. Have the record book conveniently located and indexed.
   B. Record expenses daily; do not wait for monthly statements on charge accounts or credit cards (otherwise, you may exceed the budget).
   C. Round expenses to the nearest dollar.
   D. Put a check by expenses that qualify as tax deductions.
   E. You may keep a running balance or may total each category only every month.

IV. Use a budget control sheet (Fig. 4-7) to determine whether the budget is realistic. Revise categories or decrease expenses as needed to reduce large surpluses or deficits.
   A. The fail-safe budget allows surpluses but not deficits (except for annual or semiannual expenses).
   B. The flexible budget allows short-term surpluses and deficits; appropriate for those who can discipline their spending to bring negative amounts back in line.

V. A budget must be updated frequently to take into account short-term changes, family cycle changes (such as from one income source to two or vice versa), and changes in expenses due to inflation.

VI. People may have varied reactions to the budgeting system presented.
   A. Some people recognize its appropriateness for them and should adopt it immediately.
   B. Some people feel they're managing fine without a budget.
   C. Some people feel they're managing fine with the budgeting system they have.
   D. Some people recognize their need for a budget but are skeptical about this system because of frustrating experiences with budgets before.
      1. The fail-safe budget is recommended for help with problems in paying bills on charge accounts and credit cards; or else get rid of these temptations to overextend oneself.
      2. Work out savings plan to avoid the high interest costs of buying on installment.
      3. Set aside an appropriate amount each month toward major annual or semiannual payments.

SELF-TESTING EXERCISES

True-False

_____ 1. The fail-safe budget allows deficits only for annual expenditures such as insurance payments.

_____ 2. Budgets are not as helpful for people with low-incomes as for those with high incomes.

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_____ 3. For a budget to succeed, it must be planned and imposed by the main income producer of the family.

_____ 4. Before setting up a budget, one should become aware of one's recent spending patterns.

_____ 5. A person who often is unable, when the bills come due, to pay for items charged would probably do well on a flexible budget.

_____ 6. Most people are very rational about the way they spend money.

_____ 7. The more expense categories you include in your budget, the more helpful it will be.

_____ 8. The expense category "mad money" can help people live within the constraints of a budget.

_____ 9. You should record charge purchases when you pay for them rather than at the time of purchase.

_____ 10. The short-term goal sheet should include goals to be achieved in the next 12 months.

Completion

1. If your life insurance premium for the year is $480, the monthly amount you should budget is ____________________.
2. The ____________________ expense category is one place in the budget where one can spend the amount budgeted without having to note afterward exactly how it was spent.
3. ____________________ does not uniformly increase the cost of each item in a budget.
4. The ____________________ budget is stricter than the ____________________ budget.
5. A budget is a plan of ____________________ spending.

Multiple Choice

1. In a budget, expenses should be entered

   a. daily
   b. weekly
   c. monthly
   d. annually
   e. so that none is omitted

2. How many expense categories are affected by these expenses: movie tickets, clothes, furniture, golf clubs, groceries?

   a. 2
   b. 3
   c. 4
   d. 5

3. Dirk's salary as a salesman is $800 a month. His commissions amount to $300 a month for the first nine months of the year and $600 for the last three months of the year. His monthly income from these sources is

   a. $800
   b. $950
   c. $1,075
   d. $1,175
   e. $1,200

4. You plan to spend $840 on your vacation a year from now. How much should you allot in your monthly budget to meet this goal?

   a. $70
   b. $84
   c. It depends on the interest rate.
   d. It depends on inflation.

5. Your previous month's budget had a balance forward of $96 in an expense category of $80 a month. You spent $100 this month. What is your balance forward?

a. $104
b. $84
c. $76
d. −$4
e. −$16

Cases and Problems

1. Rita is paying $107 a month for insurance, the annual premium of which is $1,200. How much extra is Rita paying for not budgeting her premiums so that she can pay them annually and thus avoid interest charges?

2. Sam has the budget below and has recorded his expenses for the month. Figure out his plus or minus and balance forward.

Expense	*Budget*	*Actual*	*Plus or Minus*	*Balance Forward*
Auto	$ 90	$ 40	$	$
Food	105	120		
Recreation	65	60		
Rent	230	230		
Other	30	35		
Total	$520	$485	$	$

3. After two months on their flexible budget in their new apartment in Wisconsin, Kate and Brad found their expense categories in the following condition:

		January		February				March
Expense Category	Budgeted Monthly Average	Actual	Plus or Minus	Balance Forward	Actual	Plus or Minus	Revised Monthly Average	Balance Forward
Housing	$ 290	$290	$ 0	$ 290	$ 290	$ 0	$	$
Utilities	75	105	− 30	45	110	− 65		
Food	190	185	+ 5	195	180	+ 15		
Recreation	90	80	+ 10	100	95	+ 5		
Clothing	100	25	+ 75	175	200	− 25		
Auto	100	60	+ 40	140	65	+ 75		
Necessities	38	48	− 10	28	23	+ 5		
Savings	75	75	0	75	75	0		
Gifts	63	13	+ 50	113	33	+ 80		
Mad money	50	50	0	50	50	0		
Total	$1,071	$931	+$140	$1,211	$1,121	+$90	$1,071	$

a. The utilities budget is way in the "red." Should they automatically increase this budget category by $30 a month?

b. They show surpluses in the auto and gifts budget. How do you interpret this fact?

c. Kate and Brad are eyeing the average $45 monthly surplus in the budget, and would like to add that to the clothing and recreation categories. What would you advise?

d. Complete the two blank columns on their control sheet, showing what changes, if any, you would make.

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4. Liz and Henry are a young couple a few years out of college. They live in San Diego in an apartment. Henry teaches at the high school and is paid on a 12-month basis. He could earn $500 more if he wanted to teach summer school. Liz has a good sales job that pays $500 a month plus commissions. Figure 4-A shows their estimated earnings for next year.

One of their New Year's resolutions is to set up a budget to help them achieve their goals (Fig. 4-B and 4-C). They want to set up a special savings account to accumulate the funds for their short- and long-term goals, drawing out funds as they are needed and letting the interest compensate for any underestimating they might have done. They have already begun to forecast their expenses (Fig. 4-D).

Other notes: they recently finished paying off their education loans and have $800 in the bank; they are still making payments on their car but want to be able to pay cash for the next one; their apartment lease expires in April and they expect a rent increase for May; they are fairly wise shoppers and take advantage of such things as post-Christmas clothing sales.

a. What monthly deposit should they make to their savings account for their goals?

b. What is their average monthly forecasted income if Henry teaches summer school?

c. What are their average monthly forecasted expenses?

d. Should Henry teach summer school?

e. What adjustments should they make in their plans?

f. What flexibility do they have if Liz's income falls short of the forecast, but they still want to meet their new car and house goals?

g. Set up monthly budgets for each expense category based on the expense forecast. Then complete the budget control sheet (Fig. 4-E) through February. How are they doing so far? Would you advise any budget revisions or spending controls?

NAME(S) Liz and Henry

DATE New Year's Day

FORECASTING INCOME

Source	Jan.	Feb.	Mar.	Apr.	May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.	Estimated 12-Month Total	Average Per Month	Actual Year's Income
Husband's take-home wages or salary	780	780	780	780	780	780	820	820	820	820	820	820			
Wife's take-home wages or salary	500	500	500	800	1,000	1,200	1,400	1,400	1,200	900	800	500			
Bonuses or commissions Summer school pay							500								
Interest	20			20			20			20					
Dividends													0		
Rents													0		
Annuities, pensions													0		
Other Grandpa's annual Christmas gift												200			
TOTAL															

Figure 4-A. Income form for use in case problem 4.

h. Do you think Liz and Henry would achieve all of their goals right on schedule if they didn't go through this budgeting process?

NAME(S) Liz and Henry

DATE New Year's Day

FORECASTING LONG-TERM GOALS

Goals	Years from Now					Beyond Five Years
	1	2	3	4	5	
House downpayment				19,200		
New car (net of trade-in)		3,000				
TOTAL						

Figure 4-B. Long-term goals form for use in case problem 4.

NAME(S) Liz and Henry

DATE New Year's Day

FORECASTING SHORT-TERM GOALS

Goals	Jan.	Feb.	Mar.	Apr.	May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.	Total	Average by Month
C.B. radio										300				
Health club membership			240											
Bedroom set		360												
Season football tickets							300							
TOTAL														

Figure 4-C. Short-term goals form for use in case problem 4.

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NAME(S) Liz and Henry

DATE New Years Day

FORECASTING EXPENSES

Expense Category	Fixed and Variable Subcategories	Jan.	Feb.	Mar.	Apr.	May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.	12-Month Total	Average by Month
Housing	Rent, mortgage payments, insurance, and taxes	240	240	240	240	260	260	260	260	260	260	260	260		
	Repairs and improvements													0	
Utilities		40	40	40	40	40	50	60	60	50	40	40	40		
Food		160	160	160	160	160	160	160	160	160	160	160	160		
Family necessities														480	
Medical	Insurance													0	
	Doctor, dentist, drugs, and hospital													120	
Clothing														840	
Automobile	Purchase payments, insurance and license fees	100	100	100	320	100	100	100	100	100	320	190	100		
	Gas, oil, repairs, parking, tolls, and so on													600	
Recreation and entertainment	General Vacation	50	30 200	50	60	60	60	60	60	30 800	60	50	50		
Personal improvement	Magazines and newspapers													270	
	Books and tuition													60	
Short-term goal fund														?	
Savings and investment	For long-term goals													?	
Outlays for fixed assets	Repairs													120	
	Purchases and installments	24	24	24	24	24	24	0	0	0	0	0	0		
Mad money														480	
Gifts														720	
Church and charity														420	
Life insurance				240			180								
Taxes														0	
Contingency	Legal services, debt repayments, union dues													240	
TOTAL BY MONTH															

Figure 4-D. Expense form for use in case problem 4.

NAME(S) Liz and Henry

DATE

BUDGET CONTROL SHEET

Expense Category	Budgeted Monthly Average	Month: Jan.		Month: Feb.			Revised Monthly Average	Month: March			Month: April		
		Actual	Plus or Minus	Balance Forward	Actual	Plus or Minus		Balance Forward	Actual	Plus or Minus	Balance Forward	Actual	Plus or Minus
Housing		240			240								
Utilities		42			44								
Food		165			168								
Family necessities		38			40								
Medical		15			0								
Clothing		175			83								
Automobile		150			148								
Recreation and entertainment		65			248								
Personal improvement		45			26								
Short-term goal fund													
Savings and investment		625			625								
Outlays for fixed assets		24			24								
Mad money													
Gifts		30			42								
Church and charity		30			30								
Life insurance		0			0								
Taxes		0			0								
Contingency		0			0								
TOTAL		1,684			1,758								

Figure 4-E. Budget control sheet for use in case problem 4.

PERSONAL MONEY MANAGEMENT ACTIVITIES

Using the five forms that follow and a book to record your expenses, set up for yourself your short- and long-term goals, forecast of expenses, forecast of income from all sources, and budget control sheet.

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NAME(S) ____________________

DATE ____________________

FORECASTING LONG-TERM GOALS

Goals	Years from Now					Beyond Five Years
	1	2	3	4	5	
TOTAL						

NAME(S) ____________________

DATE ____________________

FORECASTING SHORT-TERM GOALS

Goals	Jan.	Feb.	Mar.	Apr.	May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.	Total	Average by Month
TOTAL														

NAME(S) ____________________

DATE ____________________

FORECASTING

Expense Category	Fixed and Variable Subcategories	Jan.	Feb.
Housing	Rent, mortgage payments, insurance, and taxes		
	Repairs and improvements		
Utilities			
Food			
Family necessities			
Medical	Insurance		
	Doctor, dentist, drugs, and hospital		
Clothing			
Automobile	Purchase payments, insurance and license fees		
	Gas, oil, repairs, parking, tolls, and so on		
Recreation and entertainment	General		
Personal improvement	Magazines and newspapers		
	Books and tuition		
Short-term goal fund			
Savings and investment	For long-term goals		
Outlays for fixed assets	Repairs		
	Purchases and installments		
Mad money			
Gifts			
Church and charity			
Life insurance			
Taxes			
Contingency	Legal services, debt repayments, union dues		
TOTAL BY MONTH			

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EXPENSES

Mar.	Apr.	May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.	12-Month Total	Average by Month

NAME(S)____

DATE____

FORECASTING INCOME

Source	Jan.	Feb.	Mar.	Apr.	May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.	Estimated 12-Month Total	Average Per Month	Actual Year's Income
Husband's take-home wages or salary															
Wife's take-home wages or salary															
Bonuses or commissions															
Interest															
Dividends															
Rents															
Annuities, pensions															
Other															
TOTAL															

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NAME(S) ____

DATE ____

BUDGET CONTROL SHEET

Expense Category	Budgeted Monthly Average	Month:		Month:			Revised Monthly Average	Month:			Month:		
		Actual	Plus or Minus	Balance Forward	Actual	Plus or Minus		Balance Forward	Actual	Plus or Minus	Balance Forward	Actual	Plus or Minus
Housing													
Utilities													
Food													
Family necessities													
Medical													
Clothing													
Automobile													
Recreation and entertainment													
Personal improvement													
Short-term goal fund													
Savings and investment													
Outlays for fixed assets													
Mad money													
Gifts													
Church and charity													
Life insurance													
Taxes													
Contingency													
TOTAL													

5 · Insurance Principles

PERFORMANCE OBJECTIVES

After studying this chapter, you should be able to:

- Explain the reason for having insurance.
- Define and give examples of insurable risks and uninsurable risks.
- Explain which type of risks you might best prevent, retain, or transfer to an insurance company.
- Use your personal balance sheet and personal income statement to determine your insurance needs.
- Determine whether you have the financial capacity and the loss experience to enable you to self-insure.
- Explain how insurance premiums are determined.
- Explain how to buy insurance effectively—what to insure, against what perils, and for how much.
- Explain the role of the insurance agent.
- Describe the parts of an insurance contract.
- List and describe the different types of insurers.

OUTLINE OF THE MAIN IDEAS

I. The purpose of insurance is to protect against the risk (possibility) of financial loss.

II. Insurable risks have three characteristics.
   A. They must be fortuitous; i.e., they occur through chance and not because of deliberate action by the insured.
   B. They must cause a loss that can be measured in money. The risk of failing an exam, for example, is not insurable while the theft of a car is. Wages, bets, and investments, while they are risks, have the chance for profit and therefore are not insurable.
   C. They must be personal in origin; i.e., they do not affect large numbers of people at the same time (as war does) but affect individuals randomly (as appendectomies do).

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III. There are three ways to handle an insurable risk.
   A. Avoid or minimize it by reducing the perils that cause it; the greater the degree of risk, the higher the premium.
   B. Retain all or some of the risk yourself if (1) your financial statements show that you have the financial capacity to absorb the maximum potential loss, (2) your average annual loss (your total loss for that risk divided by the number of years) is less than the annual premium that an insurance company would charge, and (3) you can reasonably expect that your loss experience will not worsen.
      1. Deductibles are a kind of self-insurance. You accept a certain small loss in place of an uncertain large loss, which you transfer to an insurance company.
      2. Use the same procedure (in light of your monetary assets and your expected loss exposure, compare your average annual loss with the annual premium if you were to insure) to determine whether you can afford to self-insure and how large a deductible you can afford.
      3. These principles work for property, auto, and health insurance but not for life insurance since there is no previous loss experience; instead, you must consider the needs of your beneficiaries.
   C. Transfer the risk to an insurance company.
      1. Premiums are based on statistics about the loss experience of large numbers of people for various risks.
      2. To the base premium (total loss experience divided by the total number of exposures, among insured persons, to the risk) is added an amount to cover administration costs and profit.
      3. If your personal loss experience is better than that of the group and your assets are large enough to cover the maximum potential loss, self-insurance might be indicated.
      4. If the loss is likely to occur to nearly all policyholders, it is useless to insure against it since the premium will equal or exceed the loss.

IV. When buying insurance, there are five major questions to answer, the first three of which cover the variables combined in any policy.
   A. What to insure?
      1. Insure only those things the loss of which would cause you or yours a monetary loss.
      2. Therefore, identify your assets and their values.
      3. Set priorities: which assets must be insured, which should be, and which might be.
   B. What perils to insure against?
      1. Loss of health and personal property would probably have the most financial impact for most students; loss of life and income would have the most financial impact for someone with dependents.
      2. Because insurance companies put perils of equal risk into the same group, you may have to buy coverage for perils that don't apply to you.
      3. The broader the coverage, the higher the premium.
   C. How much to insure for?
      1. Determine the value of what you are insuring.
      2. Use deductibles to the extent that your emergency fund permits since they reduce premiums.
      3. The emergency fund should be large enough to withstand a six-month job loss when combined with other sources of income.
   D. How long to keep the insurance in force?
      1. Health and property insurance are normally written for one year.
      2. Keep insurance only as long as needed.
   E. How to buy the policy?
      1. Gather names of recommended agents or of agencies you want to try.
      2. Get rate quotes for the coverages and amounts desired.
      3. Evaluate the insurance companies offering the best rates.
      4. Be aware of rate trends and changes.
      5. Evaluate service and price each time you renew.

V. Insurance agents are compensated by commissions the size of which depends on the type of insurance and the amount of premiums. They may be classified according to:
  A. Type of insurance sold
    1. Property/casualty agents handle auto, home, and personal property insurance. They can bind the company before the policy is issued and can transfer coverage from one company to another.
    2. Life/health agents submit applications to the company, which decides whether to accept or reject.
  B. Their relation to the insurance companies
    1. Exclusive agents sell for one company only.
    2. Independent agents sell for several companies.

VI. The insurance contract is a legal contract that must conform to state statutes.
  A. Jacket provisions state the company's commitment to the policyholder. There are usually five:
    1. The company agrees to pay any sum the contract directs as settlement of a claim.
    2. The company outlines the expenses, if any, that it will pay in addition to the settlement.
    3. The company defines terms relating to the conditions of coverage.
    4. The company states the conditions under which the contract will be held valid.
    5. The company identifies who is to be covered and against what.
  B. Coverage provisions are the policyholder's instructions to the company as to who is to be covered against what and what is not covered.
  C. Endorsements may be added to restrict or expand coverage.

VII. The insurance company makes its profit through (1) underwriting (insuring) when actual losses are less than expected losses and (2) investing when its invested reserves earn more than investment costs. There are five types of insurance companies, all regulated by the states in which they operate. (New York and California give the best protection to the insured.)
  A. Stock companies are owned by the stockholders. They issue either participating (par) policies, which refund overcharges, or nonparticipating (nonpar) policies, which do not make refunds.
  B. Mutual companies are owned by the policyholders. Most life and health companies are mutual. Arguments as to whether stock or mutual offers the best buy are inconclusive.
  C. Health expense associations are founded by hospitals and physicians; they pay according to a fee structure. Closed-end allow services only by member hospital or physicians; open-end allow services of your choice.
  D. Lloyds of London is composed of subgroups or syndicates; they gather different kinds of risks into the same syndicate. They are licensed in only a few states.
  E. Reciprocals are composed of individual insureds who assume a proportionate share of losses incurred by any members. Found in business insurance and so are not covered here in more detail.

SELF-TESTING EXERCISES

True-False

_____ 1. The chance of flunking an exam is an insurable risk.

_____ 2. The chance of financial loss due to a fire in your home is an insurable risk.

_____ 3. The chance of loss from investing is an insurable risk.

_____ 4. To be insurable, a risk must be personal in origin.

_____ 5. Total exposures of insureds divided by total expected loss equals the base premium.

_____ 6. If there is a great probability that a loss will occur to all potential policyholders, it is wasteful to insure against it.

_____ 7. The amount of life insurance coverage to buy is more difficult to determine than property or health insurance amounts.

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_____ 8. It is in the insured's best interest always to choose a policy with the highest deductible.

_____ 9. Property/casualty agents can legally bind their companies before the policy is issued.

_____ 10. The dividend paid to the holder of a par policy by the insurance company is a distribution of the company's earnings.

Completion

1. When yield on investment of reserves is greater than the costs of investing, insurance companies are said to have an ____________________ profit.
2. Insurance companies that are owned by stockholders are said to be ____________________ companies.
3. Risks that occur because of chance are called ____________________.
4. The sum of the premium and your average annual loss or the deductible, whichever is smaller, equals your ____________________ for property, auto, or health insurance.
5. If the expected losses are lower than actual losses, the insurance company has made an ____________________ profit.
6. Stock companies that return a dividend are said to issue ____________________ policies.
7. Companies owned by the policyholders are called ____________________ companies.
8. A health expense association that allows service only by member physicians or hospital is called a(n) ____________________ association.
9. If you use deductibles, you should set up a(n) ____________________ out of which losses can be paid.
10. Risks that have a low probability of occurring but would result in large losses should be ____________________ ____________________.

Multiple Choice

1. The base premium to insure a home for $75,000 against fire loss in an area where there are 5,000 such homes and an expected annual fire loss of $1.5 million is

   a. $350
   b. $300
   c. $200
   d. $30
   e. $20

2. An insurable risk must be

   a. fortuitous
   b. personal in origin
   c. result in financial loss
   d. (All of the above)

3. If your take-home pay is $1,200 a month, the rule of thumb would give which of the following as a rough estimate of the emergency fund you should have?

   a. $1,200-$1,800
   b. $1,800-$2,400
   c. $1,800-$3,000
   d. $2,400-$30,000
   e. $2,400-$3,600

4. Over the last five years your medical expenses have been $300, $25, $75, $200, and $100. Your average annual medical expense has been

   a. $140
   b. $150
   c. $200
   d. $240
   e. $260

5. Avoiding the use of motorcycles is an example of

   a. retaining risk
   b. transferring risk
   c. minimizing risk
   d. (All of the above)
   e. (None of the above)

6. An insurance agent's income comes mainly from

   a. salaries
   b. underwriting profits
   c. investment profits
   d. commissions
   e. reserves

7. Which of the following would invoke the least financial loss for the average family?

   a. Theft of one-year-old car
   b. Total disability of the breadwinner
   c. Death of the breadwinner
   d. Total loss of home due to fire

8. Amendments to an insurance policy are called

   a. coverage provisions
   b. endorsements
   c. conditions
   d. jacket provisions
   e. declarations

Cases and Problems

1. Adam and Holly had the balance sheet below at the end of the year.

Assets		*Liabilities*	
Cash	$ 2,000	Car loan	$ 3,600
Car	4,800	Home mortgage	60,000
Personal property	15,300		
Home	80,000	Total Liabilities	$ 63,600
		Net worth	38,500
Total Assets	$102,100	Total Liabilities and Net Worth	$102,100

Their insurance agent gave them information about insurance on their home, car, and personal property as follows:

	Home		Car (Collision)		Personal Property	
Alternative	Deductible	Premium	Deductible	Premium	Deductible	Premium
1.	$ 0	$400	$ 0	$440	$ 0	$ 50
2.	100	340	100	330	50	43
3.	250	250	200	290	100	17

Since their marriage five years ago, their total losses have been $520 on their home, $2,200 from car collision, and $120 in personal property.

Given this information, which alternatives should Adam and Holly select and why?

2. Jon's car was five years old with a Blue Book value of $1,200. Over the last five years, Jon was at fault in two collisions, which cost $500 and $420, respectively. The annual cost of collision insurance is $350. If Jon has $1,500 in his emergency fund, should he retain or transfer the risk and why?

3. Bill and Mary were about to buy an $80,000 home. They had a choice of two areas shown by the realtor. Bill discovered that in area 1 there were 80 such homes with an average expected annual fire loss of $7,200. In area 2 there were 220 homes with an average annual expected fire loss of $17,600. If the basic fire premium were the sole consideration, which location should they choose and why?

PERSONAL MONEY MANAGEMENT ACTIVITIES

Use your financial statements to determine your maximum potential loss for your car (if you have one), personal property, and home (if you own one). Estimate the coverages you want. Then shop around various insurance companies and compare the rates quoted. Is there a greater disparity among the rates quoted you for auto insurance or property insurance? Compare your information with that found by others in the class and try to determine which companies offer the best rates.

ADDITIONAL ACTIVITIES

Review the sample homeowners 3 policy (pages 40–46). The general insuring agreement and declarations sections of the policy are included on the first page of the policy. The coverage provisions are also shown; they frequently appear on smaller pages than those for the rest of the policy provisions. These coverage provisions are standardized by the state in which the policy is issued and therefore are exactly the same for each type of policy regardless of the insurer (e.g., Allstate, Hartford, Aetna). Notice that the longer the coverage provision paragraphs, the more restrictive the actual protection. The shorter the paragraphs, the broader the protection. The provisions specifying the supplementary payments differ, depending on the policy. Many policies contain them on the first or second page; others, at the conclusion of the coverage provisions. Any endorsements (often called riders) are attached to the end of the policy. The policy definitions are also shown; notice the care with which they are written.

DECLARATIONS
CALIFORNIA
HOMEOWNERS
POLICY

This Declarations Page, the Forms and Endorsements issued to form a part of the policy, and the provisions contained on Pages 2 through 8, complete the below numbered Homeowners Policy.

Policy Term Years	Policy Number
Policy Period: ________ Inception ________ Expiration	

NAMED INSURED & ADDRESS (No., Street, Town or City, County, State, Zip)

The described residence premises covered hereunder is located at the above address unless otherwise stated herein (No., Street, Town or City, County, State, Zip)

Insurance is provided only with respect to the following Coverages for which a limit of liability is specified, subject to all conditions of this policy.

	SECTION I				SECTION II		
						F. Medical Payments to Others	
COVERAGES AND LIMITS OF LIABILITY	A. Dwelling	B. Appurtenant Structures	C. Unscheduled Personal Property	D. Additional Living Expense	E. Personal Liability (Bodily Injury and Property Damage) Each Occurrence	Each Person	Each Accident
	$	$	$	$	$	$	
FORMS AND ENDORSEMENTS							

PREMIUM	Basic Policy Premium	Other EQ	TOTAL PREPAID	If Paid on Install-ment	TOTAL	Pay at:	Inception	Subs. Anniv.
PREPAID	$	$	$					

DEDUCTIBLE — SECTION I: Any loss of perils insured against under Section I of this policy is subject to a deductible. Exceptions if any:

☐ Deductible applicable only to loss caused by the peril of windstorm or hail (Clause No. 1). ☐ Deductible not applicable

☐ Deductible applicable to loss caused by other perils (Clause No. 2) ☐ Special Loss Deductible Clause $

SPECIAL STATE PROVISIONS

Minnesota — Insurable Value of Dwelling $ South Carolina — Valuation Clause (Coverage A). $ New York Coinsurance Clause Applies ☐ Yes ☐ No

SECTION II — Additional residence premises, if any, located (Number, Street, Town or City, County, State, Zip)

MORTGAGEE(S) (Name and Address)

Countersignature Date Agency at ________________ Agent

In Consideration of the Provisions and Stipulations Herein or Added Hereto and of the Premium Above Specified (or specified in endorsement(s) made a part hereof), this Company, indicated above by ☒, for **the term shown above** from **inception date shown above** at 12:01 a.m. (Standard Time) to **expiration date shown above** at 12:01 a.m. (Standard Time) at location of property involved, to an amount not exceeding the limit of liability above specified, does insure **the Insured named in the Declarations above** and legal representatives, to the extent of the actual cash value of the property at the time of loss, but not exceeding the amount which it would cost to repair or replace the property with material of like kind and quality within a reasonable time after such loss, without allowance for any increased cost of repair or reconstruction by reason of any ordinance or law regulating construction or repair, and without compensation for loss resulting from interruption of business or manufacture, nor in any event for more than the interest of the insured, against all DIRECT LOSS BY FIRE, LIGHTNING AND OTHER PERILS INSURED AGAINST IN THIS POLICY INCLUDING REMOVAL FROM PREMISES ENDANGERED BY THE PERILS INSURED AGAINST IN THIS POLICY, EXCEPT AS HEREINAFTER PROVIDED, to the property described herein while located or contained as described in this policy, or pro rata for five days at each proper place to which any of the property shall necessarily be removed for preservation from the perils insured against in this policy, but not elsewhere.

Assignment of this policy shall not be valid except with the written consent of this Company.

This policy is made and accepted subject to the foregoing provisions and stipulations and those hereinafter stated, which are hereby made a part of this policy, together with such other provisions, stipulations and agreements as may be added hereto, as provided in this policy.

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HOMEOWNERS POLICY — SPECIAL FORM

This form is void unless HO-Section II is attached

HO-3
(Ed.8-71)
California

SECTION I

DESCRIPTION OF PROPERTY AND INTERESTS COVERED

COVERAGE A — DWELLING

This policy covers the described dwelling building, including additions in contact therewith, occupied principally as a private residence.

This coverage also includes:

1. if the property of the Insured and when not otherwise covered, building equipment, fixtures and outdoor equipment all pertaining to the service of the premises and while located thereon or temporarily elsewhere; and
2. materials and supplies located on the premises or adjacent thereto, intended for use in construction, alteration or repair of such dwelling.

COVERAGE B — APPURTENANT STRUCTURES

This policy covers structures (other than the described dwelling building, including additions in contact therewith) appertaining to the premises and located thereon.

This coverage also includes materials and supplies located on the premises or adjacent thereto, intended for use in construction, alteration or repair of such structures.

THIS COVERAGE EXCLUDES:

1. STRUCTURES USED IN WHOLE OR IN PART FOR BUSINESS PURPOSES; OR
2. STRUCTURES RENTED OR LEASED IN WHOLE OR IN PART OR HELD FOR SUCH RENTAL OR LEASE (EXCEPT STRUCTURES USED EXCLUSIVELY FOR PRIVATE GARAGE PURPOSES) TO OTHER THAN A TENANT OF THE DESCRIBED DWELLING.

COVERAGE C — UNSCHEDULED PERSONAL PROPERTY

This policy covers unscheduled personal property usual or incidental to the occupancy of the premises as a dwelling and owned or used by an Insured, while on the described premises and, at the option of the Named Insured, owned by others while on the portion of the premises occupied exclusively by the Insured.

This coverage also includes such unscheduled personal property while elsewhere than on the described premises, anywhere in the world:

1. owned or used by an Insured; or
2. at the option of the Named Insured,
   a. owned by a guest while in a residence occupied by an Insured; or
   b. owned by a residence employee while actually engaged in the service of an Insured and while such property is in the physical custody of such residence employee or in a residence occupied by an Insured;
3. but the limit of this Company's liability for the unscheduled personal property away from the premises shall be an additional amount of insurance equal to 10% of the amount specified for Coverage C, but in no event less than $1,000.

THIS COVERAGE EXCLUDES:

1. ANIMALS, BIRDS OR FISH;
2. MOTORIZED VEHICLES, EXCEPT SUCH VEHICLES PERTAINING TO THE SERVICE OF THE PREMISES AND NOT LICENSED FOR ROAD USE;
3. AIRCRAFT;
4. PROPERTY OF ROOMERS AND BOARDERS NOT RELATED TO THE INSURED;
5. PROPERTY CARRIED OR HELD AS SAMPLES OR FOR SALE OR FOR DELIVERY AFTER SALE;
6. PROPERTY RENTED OR HELD FOR RENTAL TO OTHERS BY THE INSURED, EXCEPT PROPERTY CONTAINED IN THAT PORTION OF THE DESCRIBED PREMISES CUSTOMARILY OCCUPIED EXCLUSIVELY BY THE INSURED AND OCCASIONALLY RENTED TO OTHERS OR PROPERTY OF THE INSURED IN THAT PORTION OF THE DESCRIBED DWELLING OCCUPIED BY ROOMERS OR BOARDERS;
7. BUSINESS PROPERTY WHILE AWAY FROM THE DESCRIBED PREMISES;
8. ANY DEVICE OR INSTRUMENT FOR THE RECORDING, REPRODUCTION OR RECORDING AND REPRODUCTION OF SOUND WHICH MAY BE OPERATED BY POWER FROM THE ELECTRICAL SYSTEM OF A MOTOR VEHICLE, OR ANY TAPE, WIRE, RECORD DISC OR OTHER MEDIUM FOR USE WITH ANY SUCH DEVICE OR INSTRUMENT WHILE ANY OF SAID PROPERTY IS IN OR UPON A MOTOR VEHICLE; OR
9. PROPERTY WHICH IS SEPARATELY DESCRIBED AND SPECIFICALLY INSURED IN WHOLE OR IN PART BY THIS OR ANY OTHER INSURANCE.

COVERAGE D — ADDITIONAL LIVING EXPENSE

If a property loss covered under this policy renders the premises untenantable, this policy covers the necessary increase in living expense incurred by the Named Insured to continue as nearly as practicable the normal standard of living of the Named Insured's household FOR NOT EXCEEDING THE PERIOD OF TIME REQUIRED:

1. TO REPAIR OR REPLACE SUCH DAMAGED OR DESTROYED PROPERTY AS SOON AS POSSIBLE; OR
2. FOR THE NAMED INSURED'S HOUSEHOLD TO BECOME SETTLED IN PERMANENT QUARTERS; WHICHEVER IS LESS.

This coverage also includes:

1. the fair rental value of any portion of the described dwelling or appurtenant structures covered under this policy, as furnished or equipped by the Named Insured, which is rented or held for rental by the Named Insured. THE FAIR RENTAL VALUE SHALL NOT INCLUDE CHARGES AND EXPENSES THAT DO NOT CONTINUE DURING THE PERIOD OF UNTENANTABILITY. COVERAGE SHALL BE LIMITED TO THE PERIOD OF TIME REQUIRED TO RESTORE, AS SOON AS POSSIBLE, THE RENTED PORTION TO THE SAME TENANTABLE CONDITION;
2. the period of time, NOT EXCEEDING TWO WEEKS, while access to the premises is prohibited by order of civil authority, as a direct result of damage to neighboring premises by a peril not otherwise excluded.

The periods described above shall not be limited by the expiration of this policy.

THIS COVERAGE EXCLUDES EXPENSE DUE TO CANCELLATION OF ANY LEASE, OR ANY WRITTEN OR ORAL AGREEMENT.

SUPPLEMENTARY COVERAGES

The following supplementary coverages SHALL NOT INCREASE THE APPLICABLE LIMIT OF LIABILITY UNDER THIS POLICY:

1. Automatic Removal: If, during the term of this policy, the Named Insured removes unscheduled personal property covered under Coverage C from the premises to another location within the Continental United States or the State of Hawaii, to be occupied as his principal residence, the limit of liability for Coverage C shall apply at each location in the proportion that the value at each location bears to the total value of all such property covered under Coverage C.

PROPERTY IN TRANSIT SHALL BE SUBJECT TO THE LIMIT OF LIABILITY FOR UNSCHEDULED PERSONAL PROPERTY AWAY FROM THE PREMISES.

This coverage shall apply ONLY FOR A PERIOD OF 30 DAYS from the date removal commences and shall then cease.

2. Debris Removal: This policy covers expenses incurred in the removal of all debris of the property covered hereunder, occasioned by loss thereto for which coverage is afforded.

3. Fire Department Service Charge: This policy covers for an amount NOT EXCEEDING $250 the Named Insured's liability, assumed by contract or agreement for fire department charges where fire department is called because of a fire in, on or exposing property insured hereunder, while located on the premises described. THIS COVERAGE DOES NOT COVER NAMED INSURED'S LIABILITY, BY CONTRACT OR OTHERWISE, TO INDEMNIFY EITHER A CITY, MUNICIPALITY OR FIRE PROTECTION DISTRICT, OR ANY OTHER PERSON, FIRM OR CORPORATION AGAINST LOSS, CLAIM OR LIABILITY ARISING BY REASONS OF THE MOVEMENT OR FUNCTIONING OF FIRE APPARATUS OR MEMBERS OF A FIRE DEPARTMENT; OR BY REASON OF ANY ACCIDENT ARISING OUT OF THE PERFORMANCE OF SERVICES BY ANY FIRE DEPARTMENT. COVERAGE AFFORDED UNDER THIS CLAUSE APPLIES ONLY IF THE PROPERTY IS NOT LOCATED WITHIN THE LIMITS OF THE CITY, MUNICIPALITY OR FIRE PROTECTION DISTRICT FURNISHING SUCH FIRE DEPARTMENT RESPONSE.

DEDUCTIBLE

Loss Deductible Clause: WITH RESPECT TO LOSS COVERED UNDER THIS POLICY, THIS COMPANY SHALL BE LIABLE ONLY WHEN SUCH LOSS IN EACH OCCURRENCE EXCEEDS $100 AND THEN ONLY FOR THE AMOUNT OF SUCH EXCESS.

THIS LOSS DEDUCTIBLE CLAUSE SHALL NOT APPLY TO COVERAGE D—ADDITIONAL LIVING EXPENSE OR FIRE DEPARTMENT SERVICE CHARGE.

PERILS INSURED AGAINST

This policy insures under:

COVERAGE A—DWELLING and COVERAGE B—APPURTENANT STRUCTURES against all risks of physical loss to the property covered (and under **COVERAGE D, ADDITIONAL LIVING EXPENSE** resulting from such loss), EXCEPT AS OTHERWISE EXCLUDED OR LIMITED.

COVERAGE C—UNSCHEDULED PERSONAL PROPERTY against direct loss to the property covered by the following perils AS DEFINED AND LIMITED, EXCEPT AS OTHERWISE EXCLUDED:

1. Fire or Lightning.

2. Removal, meaning direct loss by removal of the property covered hereunder from premises endangered by the perils insured against. The applicable limit of liability, had the property not been removed, applies pro rata for 30 days at each proper place to which any of the property shall necessarily be removed for preservation from or for repair of damages caused by the perils insured against.

3. Windstorm or Hail, EXCLUDING LOSS:

a. CAUSED DIRECTLY OR INDIRECTLY BY FROST OR COLD WEATHER OR ICE (OTHER THAN HAIL), SNOW OR SLEET, ALL WHETHER DRIVEN BY WIND OR NOT;

b. CAUSED BY RAIN, SNOW, SAND OR DUST, ALL WHETHER DRIVEN BY WIND OR NOT, UNLESS THE BUILDING CONTAINING THE PROPERTY COVERED SHALL FIRST SUSTAIN AN ACTUAL DAMAGE TO ROOF OR WALLS BY THE DIRECT FORCE OF WIND OR HAIL AND THEN THIS COMPANY SHALL BE LIABLE FOR LOSS TO THE PROPERTY COVERED THEREIN CAUSED BY RAIN, SNOW, SAND OR DUST ENTERING THE BUILDING THROUGH OPENINGS IN THE ROOF OR WALLS MADE BY DIRECT ACTION OF WIND OR HAIL; OR

c. TO WATERCRAFT (EXCEPT ROWBOATS AND CANOES ON PREMISES) INCLUDING THEIR TRAILERS, FURNISHINGS, EQUIPMENT AND OUTBOARD MOTORS WHILE SUCH PROPERTY IS NOT INSIDE FULLY ENCLOSED BUILDINGS.

4. Explosion.

5. Riot or Civil Commotion, including direct loss from pillage and looting occurring during and at the immediate place of a riot or civil commotion.

6. Aircraft, including self-propelled missiles and spacecraft.

7. Vehicles.

8. Sudden and accidental damage from smoke, OTHER THAN SMOKE FROM AGRICULTURAL SMUDGING OR INDUSTRIAL OPERATIONS.

9. Vandalism or Malicious Mischief, MEANING ONLY THE WILFUL AND MALICIOUS DAMAGE TO OR DESTRUCTION OF THE PROPERTY COVERED.

10. Theft, meaning any act of stealing or attempt thereat, including loss of property from a known place under circumstances when a probability of theft exists.

Unscheduled personal property contained in any bank, trust or safe deposit company, public warehouse or occupied dwelling not owned or occupied by or rented to an insured in which the property covered has been placed for safekeeping shall be considered as being on the described premises.

UPON KNOWLEDGE OF LOSS UNDER THIS PERIL OR OF AN OCCURRENCE WHICH MAY GIVE RISE TO A CLAIM FOR SUCH LOSS, THE INSURED SHALL GIVE IMMEDIATE NOTICE TO THIS COMPANY OR ITS AUTHORIZED AGENTS AND ALSO TO THE POLICE.

a. GENERAL THEFT EXCLUSIONS:

THIS POLICY DOES NOT APPLY TO LOSS:

(1) IF COMMITTED BY AN INSURED;

(2) IN OR TO A DWELLING UNDER CONSTRUCTION OR OF MATERIALS OR SUPPLIES THEREFOR UNTIL COMPLETED AND OCCUPIED;

(3) ARISING OUT OF OR RESULTING FROM THE THEFT OF ANY CREDIT CARD OR LOSS BY FORGERY OR ALTERATIONS OF ANY CHECK, DRAFT, PROMISSORY NOTE, BILL OF EXCHANGE, OR SIMILAR WRITTEN PROMISE, ORDER OR DIRECTION TO PAY A SUM CERTAIN IN MONEY; OR

(4) OF A PRECIOUS OR SEMI-PRECIOUS STONE FROM ITS SETTING.

b. THEFT EXCLUSIONS APPLICABLE WHILE THE DESCRIBED DWELLING IS RENTED TO OTHERS:

THIS POLICY DOES NOT APPLY TO LOSS FROM THE DESCRIBED DWELLING WHILE THE PORTION OF THE DESCRIBED DWELLING CUSTOMARILY OCCUPIED EXCLUSIVELY BY AN INSURED IS RENTED TO OTHERS:

(1) OF MONEY, BULLION, NUMISMATIC PROPERTY OR BANK NOTES;

(2) OF SECURITIES, ACCOUNTS, BILLS, DEEDS, EVIDENCES OF DEBT, LETTERS OF CREDIT, NOTES OTHER THAN BANK NOTES, PASSPORTS, RAILROAD AND OTHER TICKETS OR STAMPS, INCLUDING PHILATELIC PROPERTY;

(3) OF JEWELRY, WATCHES, NECKLACES, BRACELETS, GEMS, PRECIOUS AND SEMI-PRECIOUS STONES; ARTICLES OF GOLD AND PLATINUM; OR ANY ARTICLE OF FUR OR ARTICLE CONTAINING FUR WHICH REPRESENTS ITS PRINCIPAL VALUE; OR

(4) CAUSED BY A TENANT, HIS EMPLOYEES OR MEMBERS OF HIS HOUSEHOLD WHILE RENTING THE PORTION OF THE DESCRIBED DWELLING CUSTOMARILY OCCUPIED EXCLUSIVELY BY AN INSURED.

c. THEFT EXCLUSIONS APPLICABLE TO PROPERTY AWAY FROM THE DESCRIBED PREMISES:

THIS POLICY DOES NOT APPLY TO LOSS AWAY FROM THE DESCRIBED PREMISES OF:

(1) PROPERTY WHILE IN ANY DWELLING OR PREMISES THEREOF, OWNED, RENTED OR OCCUPIED BY AN INSURED, EXCEPT WHILE AN INSURED IS TEMPORARILY RESIDING THEREIN;

(2) PROPERTY WHILE UNATTENDED IN OR ON ANY MOTOR VEHICLE OR TRAILER, OTHER THAN A PUBLIC CONVEYANCE, UNLESS THE LOSS IS THE RESULT OF FORCIBLE ENTRY INTO SUCH VEHICLE WHILE ALL DOORS, WINDOWS OR OTHER OPENINGS THEREOF ARE CLOSED AND LOCKED, PROVIDED THERE ARE VISIBLE MARKS OF FORCIBLE ENTRY UPON THE EXTERIOR OF SUCH VEHICLE OR THE LOSS IS THE RESULT OF THE THEFT OF SUCH VEHICLE WHICH IS NOT RECOVERED WITHIN 30 DAYS, BUT PROPERTY SHALL NOT BE CONSIDERED UNATTENDED WHEN THE INSURED IS REQUIRED TO SURRENDER THE KEYS OF SUCH VEHICLE TO A BAILEE;

(3) PROPERTY WHILE UNATTENDED IN OR ON PRIVATE WATERCRAFT UNLESS THE LOSS IS THE DIRECT RESULT OF FORCIBLE ENTRY INTO A SECURELY LOCKED COMPARTMENT AND PROVIDED THERE ARE VISIBLE MARKS OF FORCIBLE ENTRY UPON THE EXTERIOR OF SUCH COMPARTMENT;

(4) WATERCRAFT, THEIR FURNISHINGS, EQUIPMENT AND OUTBOARD MOTORS; OR

(5) TRAILERS, WHETHER LICENSED OR NOT.

11. Falling objects, BUT EXCLUDING LOSS TO PROPERTY WITHIN A BUILDING, UNLESS THE BUILDING CONTAINING THE PROPERTY COVERED SHALL FIRST SUSTAIN AN ACTUAL DAMAGE TO THE EXTERIOR OF THE ROOF OR WALLS BY THE FALLING OBJECT.

12. Weight of ice, snow or sleet, but only with respect to property contained in a building AND THEN ONLY IF THE WEIGHT OF ICE, SNOW OR SLEET RESULTS IN PHYSICAL DAMAGE TO SUCH BUILDING.

13. Collapse of buildings or any part thereof, BUT COLLAPSE DOES NOT INCLUDE SETTLING, CRACKING, SHRINKAGE, BULGING OR EXPANSION.

14. Sudden and accidental tearing asunder, cracking, burning or bulging of a steam or hot water heating system or of appliances for heating water, BUT NOT INCLUDING LOSS CAUSED BY OR RESULTING FROM FREEZING.

15. Accidental discharge, leakage or overflow of water or steam from within a plumbing, heating or air conditioning system or from within a domestic appliance BUT EXCLUDING LOSS TO THE APPLIANCE FROM WHICH THE WATER OR STEAM ESCAPES. THIS PERIL DOES NOT INCLUDE LOSS CAUSED BY OR RESULTING FROM FREEZING.

16. Freezing of plumbing, heating and air conditioning systems and domestic appliances.

17. Sudden and accidental injury from electrical currents artificially generated to electrical appliances, devices, fixtures and wiring, EXCEPT TUBES, TRANSISTORS AND SIMILAR ELECTRONIC COMPONENTS.

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ADDITIONAL EXCLUSIONS

THIS POLICY DOES NOT INSURE AGAINST LOSS:

Under Coverages A, B and C (and under **Coverage D—Additional Living Expense** resulting from such loss):

1. CAUSED BY, RESULTING FROM, CONTRIBUTED TO OR AGGRAVATED BY ANY OF THE FOLLOWING:

a. FLOOD, SURFACE WATER, WAVES, TIDAL WATER OR TIDAL WAVE, OVERFLOW OF STREAMS OR OTHER BODIES OF WATER, OR SPRAY FROM ANY OF THE FOREGOING, ALL WHETHER DRIVEN BY WIND OR NOT;

b. WATER WHICH BACKS UP THROUGH SEWERS OR DRAINS; OR

c. WATER BELOW THE SURFACE OF THE GROUND INCLUDING THAT WHICH EXERTS PRESSURE ON OR FLOWS, SEEPS OR LEAKS THROUGH SIDEWALKS, DRIVEWAYS, FOUNDATIONS, WALLS, BASEMENT OR OTHER FLOORS OR THROUGH DOORS, WINDOWS OR ANY OTHER OPENINGS IN SUCH SIDEWALKS, DRIVEWAYS, FOUNDATIONS, WALLS, OR FLOORS;

UNLESS LOSS BY FIRE OR EXPLOSION ENSUES, AND THIS COMPANY SHALL THEN BE LIABLE ONLY FOR SUCH ENSUING LOSS, BUT THESE EXCLUSIONS DO NOT APPLY TO LOSS BY THEFT;

2. CAUSED BY, RESULTING FROM, CONTRIBUTED TO OR AGGRAVATED BY ANY EARTH MOVEMENT, INCLUDING BUT NOT LIMITED TO EARTHQUAKE, VOLCANIC ERUPTION, LANDSLIDE, MUDFLOW, EARTH SINKING, RISING OR SHIFTING; UNLESS LOSS BY FIRE, EXPLOSION OR BREAKAGE OF GLASS CONSTITUTING A PART OF THE BUILDING(S) COVERED HEREUNDER, INCLUDING GLASS IN STORM DOORS AND STORM WINDOWS, ENSUES, AND THIS COMPANY SHALL THEN BE LIABLE ONLY FOR SUCH ENSUING LOSS, BUT THIS EXCLUSION DOES NOT APPLY TO LOSS BY THEFT;

3. TO PLUMBING, HEATING OR AIR CONDITIONING SYSTEMS OR DOMESTIC APPLIANCES, OR BY DISCHARGE, LEAKAGE OR OVERFLOW FROM SUCH SYSTEMS OR APPLIANCES, CAUSED BY OR RESULTING FROM FREEZING WHILE THE BUILDING COVERED IS VACANT OR UNOCCUPIED UNLESS THE INSURED SHALL HAVE EXERCISED DUE DILIGENCE WITH RESPECT TO MAINTAINING HEAT IN THE BUILDING OR UNLESS SUCH SYSTEMS AND APPLIANCES HAD BEEN DRAINED AND THE WATER SUPPLY SHUT OFF DURING SUCH VACANCY OR UNOCCUPANCY;

4. OCCASIONED DIRECTLY OR INDIRECTLY BY ENFORCEMENT OF ANY LOCAL OR STATE ORDINANCE OR LAW REGULATING THE CONSTRUCTION, REPAIR, OR DEMOLITION OF BUILDING(S) OR STRUCTURE(S) UNLESS SUCH LIABILITY IS OTHERWISE SPECIFICALLY ASSUMED BY ENDORSEMENT HEREON;

5. TO FENCES, PAVEMENTS, PATIOS, SWIMMING POOLS, FOUNDATIONS, RETAINING WALLS, BULKHEADS, PIERS, WHARVES OR DOCKS WHEN SUCH LOSS IS CAUSED BY FREEZING, THAWING OR BY THE PRESSURE OR WEIGHT OF ICE OR WATER WHETHER DRIVEN BY WIND OR NOT;

6. CAUSED BY OR RESULTING FROM POWER, HEATING OR COOLING FAILURE, UNLESS SUCH FAILURE RESULTS FROM PHYSICAL DAMAGE TO POWER, HEATING OR COOLING EQUIPMENT SITUATED ON THE PREMISES, CAUSED BY A PERIL NOT OTHERWISE EXCLUDED.

Under Coverages A and B (and under **Coverage D—Additional Living Expense** resulting from such loss):

1. BY WEAR AND TEAR; MARRING OR SCRATCHING; DETERIORATION; INHERENT VICE; LATENT DEFECT; MECHANICAL BREAKDOWN; RUST; MOLD; WET OR DRY ROT; CONTAMINATION; SMOG; SMOKE FROM AGRICULTURAL SMUDGING OR INDUSTRIAL OPERATIONS; SETTLING, CRACKING, SHRINKAGE, BULGING OR EXPANSION OF PAVEMENTS, PATIOS, FOUNDATIONS, WALLS, FLOORS, ROOFS OR CEILINGS; BIRDS, VERMIN, RODENTS, INSECTS OR DOMESTIC ANIMALS; UNLESS LOSS BY FIRE, SMOKE (OTHER THAN SMOKE FROM AGRICULTURAL SMUDGING OR INDUSTRIAL OPERATIONS), EXPLOSION, COLLAPSE OF A BUILDING, GLASS BREAKAGE OR WATER NOT OTHERWISE EXCLUDED ENSUES, THEN THIS POLICY SHALL COVER ONLY SUCH ENSUING LOSS. IF LOSS BY WATER NOT OTHERWISE EXCLUDED ENSUES, THIS POLICY SHALL ALSO COVER THE COST OF TEARING OUT AND REPLACING OF ANY PART OF THE BUILDING COVERED REQUIRED TO EFFECT REPAIRS TO THE PLUMBING, HEATING OR AIR CONDITIONING SYSTEM OR DOMESTIC APPLIANCE BUT EXCLUDING LOSS TO THE SYSTEM OR APPLIANCE FROM WHICH THE WATER ESCAPES;

2. BY THEFT IN OR TO A DWELLING UNDER CONSTRUCTION OR OF MATERIALS OR SUPPLIES THEREFOR UNTIL COMPLETED AND OCCUPIED;

3. BY VANDALISM AND MALICIOUS MISCHIEF OR GLASS BREAKAGE, IF THE PROPERTY COVERED HEREUNDER HAD BEEN VACANT BEYOND A PERIOD OF 30 CONSECUTIVE DAYS IMMEDIATELY PRECEDING THE LOSS.

4. BY WIND, HAIL, ICE, SNOW OR SLEET TO OUTDOOR RADIO AND TELEVISION ANTENNAS INCLUDING THEIR LEAD-IN WIRING, MASTS OR TOWERS;

5. LOSS CAUSED BY CONTINUOUS OR REPEATED SEEPAGE OR LEAKAGE OF WATER OR STEAM FROM WITHIN A PLUMBING, HEATING OR AIR CONDITIONING SYSTEM OR FROM WITHIN A DOMESTIC APPLIANCE WHICH OCCURS OVER A PERIOD OF WEEKS, MONTHS OR YEARS.

ADDITIONAL CONDITIONS

1. Replacement Cost — Coverages A and B:

THIS CONDITION SHALL BE APPLICABLE ONLY TO A BUILDING STRUCTURE COVERED HEREUNDER EXCLUDING OUTDOOR RADIO AND TELEVISION ANTENNAS AND AERIALS, CARPETING, AWNINGS, DOMESTIC APPLIANCES AND OUTDOOR EQUIPMENT, ALL WHETHER ATTACHED TO THE BUILDING STRUCTURE OR NOT.

a. IF AT THE TIME OF LOSS THE WHOLE AMOUNT OF INSURANCE APPLICABLE TO SAID BUILDING STRUCTURE FOR THE PERIL CAUSING THE LOSS IS 80% OR MORE OF THE FULL REPLACEMENT COST OF SUCH BUILDING STRUCTURE, THE COVERAGE OF THIS POLICY APPLICABLE TO SUCH BUILDING STRUCTURE IS EXTENDED TO INCLUDE THE FULL COST OF REPAIR OR REPLACEMENT (WITHOUT DEDUCTION FOR DEPRECIATION).

b. IF AT THE TIME OF LOSS THE WHOLE AMOUNT OF INSURANCE APPLICABLE TO SAID BUILDING STRUCTURE FOR THE PERIL CAUSING THE LOSS IS LESS THAN 80% OF THE FULL REPLACEMENT COST OF SUCH BUILDING STRUCTURE, THIS COMPANY'S LIABILITY FOR LOSS UNDER THIS POLICY SHALL NOT EXCEED THE LARGER OF THE FOLLOWING AMOUNTS (1) OR (2):

(1) THE ACTUAL CASH VALUE OF THAT PART OF THE BUILDING STRUCTURE DAMAGED OR DESTROYED; OR

(2) THAT PROPORTION OF THE FULL COST OF REPAIR OR REPLACEMENT WITHOUT DEDUCTION FOR DEPRECIATION OF THAT PART OF THE BUILDING STRUCTURE DAMAGED OR DESTROYED, WHICH THE WHOLE AMOUNT OF INSURANCE APPLICABLE TO SAID BUILDING STRUCTURE FOR THE PERIL CAUSING THE LOSS BEARS TO 80% OF THE FULL REPLACEMENT COST OF SUCH BUILDING STRUCTURE.

c. THIS COMPANY'S LIABILITY FOR LOSS UNDER THIS POLICY SHALL NOT EXCEED THE SMALLEST OF THE FOLLOWING AMOUNTS (1), (2), OR (3):

(1) THE LIMIT OF LIABILITY OF THIS POLICY APPLICABLE TO THE DAMAGED OR DESTROYED BUILDING STRUCTURE;

(2) THE REPLACEMENT COST OF THE BUILDING STRUCTURE OR ANY PART THEREOF IDENTICAL WITH SUCH BUILDING STRUCTURE ON THE SAME PREMISES AND INTENDED FOR THE SAME OCCUPANCY AND USE; OR

(3) THE AMOUNT ACTUALLY AND NECESSARILY EXPENDED IN REPAIRING OR REPLACING SAID BUILDING STRUCTURE OR ANY PART THEREOF INTENDED FOR THE SAME OCCUPANCY AND USE.

d. WHEN THE FULL COST OF REPAIR OR REPLACEMENT IS MORE THAN $1,000 OR MORE THAN 5% OF THE WHOLE AMOUNT OF INSURANCE APPLICABLE TO SAID BUILDING STRUCTURE FOR THE PERIL CAUSING THE LOSS, THIS COMPANY SHALL NOT BE LIABLE FOR ANY LOSS UNDER PARAGRAPH a. OR SUB-PARAGRAPH (2) OF PARAGRAPH b. OF THIS CONDITION UNLESS AND UNTIL ACTUAL REPAIR OR REPLACEMENT IS COMPLETED.

e. IN DETERMINING IF THE WHOLE AMOUNT OF INSURANCE APPLICABLE TO SAID BUILDING STRUCTURE IS 80% OR MORE OF THE FULL REPLACEMENT COST OF SUCH BUILDING STRUCTURE, THE COST OF EXCAVATIONS, UNDERGROUND FLUES AND PIPES, UNDERGROUND WIRING AND DRAINS, AND BRICK, STONE AND CONCRETE FOUNDATIONS, PIERS AND OTHER SUPPORTS WHICH ARE BELOW THE UNDER SURFACE OF THE LOWEST BASEMENT FLOOR, OR WHERE THERE IS NO BASEMENT, WHICH ARE BELOW THE SURFACE OF THE GROUND INSIDE THE FOUNDATION WALLS, SHALL BE DISREGARDED.

f. THE NAMED INSURED MAY ELECT TO DISREGARD THIS CONDITION IN MAKING CLAIM HEREUNDER, BUT SUCH ELECTION SHALL NOT PREJUDICE THE NAMED INSURED'S RIGHT TO MAKE FURTHER CLAIM WITHIN 180 DAYS AFTER LOSS FOR ANY ADDITIONAL LIABILITY BROUGHT ABOUT BY THIS POLICY CONDITION.

2. Special Limits of Liability on Certain Property:

a. This Company shall be liable for loss to trees, shrubs, plants and lawns (EXCEPT THOSE GROWN FOR BUSINESS PURPOSES) ONLY WHEN THE LOSS IS CAUSED BY FIRE, LIGHTNING, EXPLOSION, RIOT, CIVIL COMMOTION, VANDALISM, MALICIOUS MISCHIEF, THEFT, AIRCRAFT, OR VEHICLES NOT OWNED OR OPERATED BY AN OCCUPANT OF THE PREMISES. THIS COMPANY'S LIABILITY FOR LOSS IN ANY ONE OCCURRENCE UNDER THIS PROVISION SHALL NOT EXCEED IN THE AGGREGATE FOR

ALL SUCH PROPERTY 5% OF THE LIMIT OF LIABILITY OF COVERAGE A, NOR MORE THAN $250 ON ANY ONE TREE, SHRUB OR PLANT, INCLUDING EXPENSE INCURRED FOR REMOVING DEBRIS THEREOF.

b. UNDER COVERAGE C, THIS COMPANY SHALL NOT BE LIABLE FOR LOSS IN ANY ONE OCCURRENCE WITH RESPECT TO THE FOLLOWING PROPERTY FOR MORE THAN:

(1) $100 IN THE AGGREGATE ON MONEY, BULLION, NUMISMATIC PROPERTY AND BANK NOTES;
(2) $500 IN THE AGGREGATE ON SECURITIES, ACCOUNTS, BILLS, DEEDS, EVIDENCES OF DEBT, LETTERS OF CREDIT, NOTES OTHER THAN BANK NOTES, PASSPORTS, RAILROAD AND OTHER TICKETS OR STAMPS, INCLUDING PHILATELIC PROPERTY;
(3) $1,000 ON MANUSCRIPTS;
(4) $500 IN THE AGGREGATE FOR LOSS BY THEFT OF JEWELRY, WATCHES, NECKLACES, BRACELETS, GEMS, PRECIOUS AND SEMI-PRECIOUS STONES, GOLD, PLATINUM AND FURS INCLUDING ARTICLES CONTAINING FUR WHICH REPRESENTS ITS PRINCIPAL VALUE;
(5) $500 IN THE AGGREGATE ON WATERCRAFT, INCLUDING THEIR TRAILERS (WHETHER LICENSED OR NOT), FURNISHINGS, EQUIPMENT AND OUTBOARD MOTORS; OR
(6) $500 ON TRAILERS, NOT OTHERWISE PROVIDED FOR, WHETHER LICENSED OR NOT.

3. Loss Clause:
Loss hereunder shall not reduce the applicable limit of liability under this policy.

4. Mortgage Clause — Coverages A and B only: (This entire clause is void unless name of mortgagee [or trustee] is inserted in the Declarations):

Loss, if any, under this policy, shall be payable to the mortgagee (or trustee), named on the first page of this policy, as interest may appear, under all present or future mortgages upon the property herein described in which the aforesaid may have an interest as mortgagee (or trustee), in order of precedence of said mortgages, and this insurance as to the interest of the mortgagee (or trustee) only therein, shall not be invalidated by any act or neglect of the mortgagor or owner of the within described property, nor by any foreclosure or other proceedings or notice of sale relating to the property, nor by any change in the title or ownership of the property, nor by the occupation of the premises for purposes more hazardous than are permitted by this policy; provided, that in case the mortgagor or owner shall neglect to pay any premium due under this policy, the mortgagee (or trustee) shall, on demand, pay the same.

Provided also, that the mortgagee (or trustee) shall notify this Company of any change of ownership or occupancy or increase of hazard which shall come to the knowledge of said mortgagee (or trustee) and, unless permitted by this policy, it shall be noted thereon and the mortgagee (or trustee) shall, on demand, pay the premium for such increased hazard for the term of the use thereof, otherwise this policy shall be null and void.

This Company reserves the right to cancel this policy at any time as provided by its terms but in such case this policy shall continue in force for the benefit only of the mortgagee (or trustee) for ten days after notice to the mortgagee (or trustee) of such cancellation and shall then cease, and this Company shall have the right, on like notice to cancel this agreement.

Whenever this Company shall pay the mortgagee (or trustee) any sum for loss under this policy, and shall claim that, as to the mortgagor or owner, no liability therefor existed, this Company shall, to the extent of such payment, be thereupon legally subrogated to all the rights of the party to whom such payment shall be made, under all securities held as collateral to the mortgage debt; or may at its option pay to the mortgagee (or trustee) the whole principal due or to grow due on the mortgage, with interest accrued and shall thereupon receive a full assignment and transfer of the mortgage and of all such other securities; but no subrogation shall impair the right of the mortgagee (or trustee) to recover the full amount of said mortgagee's (or trustee's) claim.

5. Occupancy Clause: IT IS A CONDITION OF THIS POLICY THAT IF THE DESCRIBED DWELLING IS ASSOCIATED WITH AND IN PROXIMITY TO FARMING OPERATIONS (1) THE AGRICULTURAL PRODUCTS PRODUCED ON THE LAND ARE INCIDENTAL TO THE OCCUPANCY OF THE DWELLING AND ARE PRINCIPALLY FOR HOME CONSUMPTION, OR (2) THAT THE OCCUPANTS OF THE DWELLING AND BUILDINGS APPURTENANT THERETO ARE NOT ENGAGED IN THE OPERATION OF THE FARM AND SAID BUILDINGS ARE IN ADDIDTION TO A COMPLETE SET OF FARM BUILDINGS ON THE FARM AND ARE NOT EXPOSED WITHIN 200 FEET BY ANY FARM BUILDING.

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HOMEOWNERS POLICY — COMPREHENSIVE PERSONAL LIABILITY
CONDITIONS APPLICABLE TO SECTION II

HO-SECTION II
(Ed. 9-70)
California

COVERAGES

COVERAGE E — PERSONAL LIABILITY

This Company agrees to pay on behalf of the Insured all sums which the Insured shall become legally obligated to pay as damages because of bodily injury or property damage, to which this insurance applies, caused by an occurrence. This Company shall have the right and duty, at its own expense, to defend any suit against the Insured seeking damages on account of such bodily injury or property damage, even if any of the allegations of the suit are groundless, false or fraudulent, but may make such investigation and settlement of any claim or suit as it deems expedient. This Company shall not be obligated to pay any claim or judgment or to defend any suit after the applicable limit of this Company's liability has been exhausted by payment of judgments or settlements.

COVERAGE F — MEDICAL PAYMENTS TO OTHERS

This Company agrees to pay all reasonable medical expenses, incurred within one year from the date of the accident, to or for each person who sustains bodily injury to which this insurance applies caused by an accident, while such person is:

1. on an insured premises with the permission of any Insured; or
2. elsewhere, if such bodily injury
   a. arises out of a condition in the insured premises or the ways immediately adjoining,
   b. is caused by the activities of any Insured, or by a residence employee in the course of his employment by any Insured,
   c. is caused by an animal owned by or in the care of any Insured, or
   d. is sustained by any residence employee and arises out of and in the course of his employment by any Insured.

EXCLUSIONS

This policy does not apply:

1. **Under Coverage E — Personal Liability and Coverage F — Medical Payments to Others:**

   a. to bodily injury or property damage arising out of the ownership, maintenance, operation, use, loading or unloading of:

      (1) any aircraft; or

      (2) any motor vehicle owned or operated by, or rented or loaned to any Insured; but this subdivision (2) does not apply to bodily injury or property damage occurring on the residence premises if the motor vehicle is not subject to motor vehicle registration because it is used exclusively on the residence premises or kept in dead storage on the residence premises; or

      (3) any recreational motor vehicle owned by any Insured, if the bodily injury or property damage occurs away from the residence premises; but this subdivision (3) does not apply to golf carts while used for golfing purposes.

   This exclusion does not apply to bodily injury to any residence employee arising out of and in the course of his employment by any Insured except while such employee is engaged in the operation or maintenance of aircraft;

   b. to bodily injury or property damage arising out of the ownership, maintenance, operation, use, loading or unloading of any watercraft:

      (1) owned by or rented to any Insured if the watercraft has inboard or inboard-outboard motor power of more than 50 horsepower or is a sailing vessel (with or without auxiliary power) 26 feet or more in overall length; or

      (2) powered by any outboard motor(s), singly or in combination of more than 25 total horsepower, if such outboard motor(s) is owned by any Insured at the inception of this policy and not endorsed hereon, unless the Insured reports in writing to this Company within 45 days after acquisition his intention to insure the outboard motor or combination of outboard motors, ownership of which was acquired prior to the policy term.

   This exclusion does not apply to (a) bodily injury or property damage occurring on the residence premises or (b) bodily injury to any residence employee arising out of and in the course of his employment by any Insured;

   c. to bodily injury or property damage arising out of the rendering of or failing to render professional services;

   d. to bodily injury or property damage arising out of business pursuits of any Insured except activities therein which are ordinarily incident to non-business pursuits;

   e. to bodily injury or property damage arising out of any premises, other than an insured premises, owned, rented or controlled by any Insured; but this exclusion does not apply to bodily injury to any residence employee arising out of and in the course of his employment by any Insured;

   f. to bodily injury or property damage which is either expected or intended from the standpoint of the Insured.

2. **Under Coverage E — Personal Liability**

   a. to liability assumed by the Insured under any contract or agreement not in writing or under any contract or agreement in connection with the Insured's business;

   b. to bodily injury to any person, including a residence employee, if the Insured has a policy providing workmen's compensation or occupational disease benefits for such bodily injury or if benefits for such bodily injury are in whole or in part either payable or required to be provided by the Insured under any workmen's compensation or occupational disease law;

   c. to property damage to property owned by the Insured;

   d. to property damage to property occupied or used by the Insured or rented to or in the care, custody or control of the Insured or as to which the Insured is for any purpose exercising physical control;

   e. to sickness, disease or death resulting therefrom of any residence employee unless written claim is made or suit is brought therefor against the Insured within 36 months after the end of the policy term.

3. **Under Coverage F — Medical Payments to Others**

   a. to bodily injury to any person, including a residence employee, if any person or organization has a policy providing workmen's compensation or occupational disease benefits for such bodily injury or if benefits for such bodily injury are in whole or in part either payable or required to be provided under any workmen's compensation or occupational disease law;

   b. to bodily injury to

      (1) any Insured under parts (1) and (2) of the definition of "Insured",

      (2) any person, other than a residence employee, regularly residing on any part of the insured premises, or

      (3) any person while on the insured premises because a business is conducted or professional services are rendered thereon.

SUPPLEMENTARY COVERAGES

1. **Damage to Property of Others:** This Company will, at its option, either pay for the actual cash value of property damaged or destroyed during the policy period by any Insured, or repair or replace such property with other property of like quality and kind, but in no event shall this Company's limit of liability exceed $250 in any one occurrence.

   This coverage does not apply to damage to or destruction of property:

   a. caused intentionally by any Insured who has attained the age of 13;

   b. owned by or rented to any Insured, any tenant of any Insured or any resident of Named Insured's household;

   c. arising out of (1) any act or omission in connection with premises (other than the insured premises) owned, rented or controlled by any Insured, (2) business pursuits or professional services or (3) the ownership, maintenance, operation, use, loading or unloading of any land motor vehicle, trailer or semi-trailer, farm machinery or equipment, aircraft or watercraft;

   d. if insurance therefor is provided under Section I of this policy.

2. **Personal Liability Claim Expenses:** This Company will pay:

   a. all expenses incurred by this Company and all costs taxed against the Insured in any suit defended by this Company;

   b. all premiums on appeal bonds required in any such suit, premiums on bonds to release attachments in any such suit for an amount not in excess of the applicable limit of liability of this policy, and the cost of bail bonds required of the Insured because of accident or traffic law violation arising out of the use of any vehicle to which this policy applies, not to exceed $250 per bail bond, but this Company shall have no obligation to apply for or furnish any such bonds;

   c. all interest on the entire amount of any judgment which accrues after entry of the judgment and before this Company has paid or tendered or deposited in court that part of the judgment which does not exceed the limit of this Company's liabilty thereon;

   d. reasonable expenses incurred by the Insured at this Company's request, including actual loss of earnings (but not loss of other income) not to exceed $25 per day because of his attendance at hearings or trials at such request.

   Any expenses incurred by this Company under this provision shall not reduce the applicable limit of liability.

3. **First Aid Expenses:** In addition to this Company's limit of liability, this Company will pay expenses incurred by the Insured for first aid to others at the time of an accident, for bodily injury to which this insurance applies.

4. **Property in Control of the Insured:** Such insurance as is afforded under Coverage E — Personal Liability, applies to property damage to any insured premises and to house furnishings therein if such property damage arises out of fire, explosion, or smoke or smudge caused by sudden, unusual and faulty operation of any heating or cooking unit. Exclusion 2.d. does not apply to this Supplementary Coverage.

5. **Construction of New Residence:** Such insurance as is afforded under Coverage E — Personal Liability, applies to bodily injury and property damage arising out of any vacant land owned by or rented to any Insured on which a one or two family dwelling is being constructed for use by any Insured as a residence. Such insurance as is afforded under Coverage F — Medical Payments to Others, applies to bodily injury sustained by any person while on such vacant land with the permission of any Insured. This coverage does not apply to bodily injury to any employee, other than a residence employee, of any Insured arising out of and in the course of his employment by any Insured. Exclusion 1.e. does not apply to this Supplementary Coverage.

ADDITIONAL DEFINITIONS

The following definitions apply only to coverage afforded under Section II of this policy.

1. **"bodily injury"**: means bodily injury, sickness or disease, including care, loss of services and death resulting therefrom.

2. **"medical expenses"**: means expenses for necessary medical, surgical, x-ray, dental services, including prosthetic devices, ambulance, hospital, professional nursing and funeral services.

3. **"motor vehicle"**: means a land motor vehicle, trailer or semi-trailer designed for travel on public roads (including any machinery or apparatus attached thereto) but does not include, except while being towed by or carried on a motor vehicle, any of the following: utility, boat, camp or home trailer, recreational motor vehicle, crawler or farm type tractor, farm implement or, if not subject to motor vehicle registration, any equipment which is designed for use principally off public roads.

4. **"property damage"**: means injury to or destruction of tangible property, including loss of use thereof.

5. **"occurrence"**: means an accident, including injurious exposure to conditions, which results, during the policy term, in bodily injury or property damage.

6. **"recreational motor vehicle"**: means (1) a golf cart or snowmobile or (2) if not subject to motor vehicle registration, any other land motor vehicle designed for recreational use off public roads.

7. **"residence employee"**: means an employee of any Insured whose duties are in connection with the maintenance or use of the insured premises, including the performance of household or domestic services, or who performs elsewhere duties of a similar nature not in connection with any Insured's business.

Sections I and II are otherwise subject to the conditions set forth in this policy to which this form is attached.

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6 · Property Insurance

PERFORMANCE OBJECTIVES

After studying this chapter, you should be able to:

- Explain what kinds of property you can and should insure.
- Make an inventory of your personal property and explain the uses of such an inventory.
- Explain how to compute market value and replacement value and why the latter is generally preferable for insuring both personal and real property.
- Explain how the coinsurance principle works and why it is important.
- Describe the various kinds of policies offered and choose those best suited to your needs.
- Describe how certain limiting clauses in policies can affect your protection.
- Explain how premiums are determined and the various ways you can lower the cost of property insurance.

OUTLINE OF THE MAIN IDEAS

I. You can insure only property (physical structures and personal property) that belongs to you and has a determinable value; land is not insurable.
   A. Specifically, you can insure your home and attached or detached structures; trees, plants, shrubbery; personal property on or off the premises; personal property of others on the premises; and added living expenses if you are forced out of your home.
   B. Property that is difficult to evaluate or that has a high risk of loss can be insured only at higher premiums.

II. Before buying insurance on your personal property, you need to know its value.
   A. An inventory of personal property, room by room, enables you to know the amount of potential loss and, should the need arise, to prove it.
      1. You should distribute valuable property evenly throughout the house.
      2. Take pictures to help verify a claim.

3. Keep the inventory sheets in a safe-deposit box.
4. Keep the inventory current.

B. *Market value* of an item is the dollar value you would realize if you sold it.
1. It reflects both upward (appreciation) and downward (depreciation) changes from the item's original purchase price.
2. Depreciation schedules can be used to determine the market value of one's personal property.

C. *Replacement cost* of an item is the dollar value you would have to spend to replace it.
1. For an added premium, normally 15 percent of the premium, you can insure for replacement cost.
2. This extra cost may be worthwhile if your personal property is old.

III. Before buying insurance on your home, you need to know its value. The replacement cost of a home is usually greater than its market value (excluding about 20 percent for the land).

A. Determine replacement cost by multiplying local construction costs per square foot times the number of square feet in the structure.

B. According to the coinsurance clause, if 80 percent of the replacement is carried, the company will reimburse the full amount of the loss (not to exceed the amount of the policy). If less is carried, it pays only that fraction of the total loss which the actual amount in force bears to the 80 percent required.

C. When you insure for replacement cost, you need to keep up with inflationary increases in construction costs. For an extra fee, some companies assume the obligation of keeping the face value of the policy at 80 percent or above and, if it falls below the 80 percent, the policyholder is not penalized.

IV. Once you know what you have and its value, you must determine what perils you want to protect it against and choose the appropriate type of policy.

A. Use the list of perils commonly covered (Table 6-3 note) to decide which coverage you need. Risks seldom, if ever, covered include heat or scorching, self-inflicted hazards, snowstorms, tidal waves, floods, earthquakes, and war.

B. There are four groups of policies that cover home or personal property, or both:
1. Standard fire covers home and other structures against loss due to fire.
2. Dwelling building(s) and contents are used primarily by apartment owners to cover their rental property.
3. Homeowners forms are designed for homeowners and renters.
4. Floaters cover personal property anywhere in the world; they are used to cover items of high value.

C. Homeowners policies provide the broadest coverage for both home and personal property. They do the following:
1. Cover the dwelling; detached structures on the premises; unscheduled personal property on and off the premises; trees, plants, and shrubs; and added living expenses.
2. Cover all personal property while in transit up to 10 percent of the face amount and while at a new location for a maximum of 30 days up to 50 percent of the face amount of the policy.
3. Cover the cost of removing debris caused by the covered damage.
4. Pay fire department costs up to $250.
5. Impose specified limits of coverage for theft on specified items.
6. Include personal liability and medical expense coverage of a maximum of $25,000 liability per occurrence, $500 in medical expenses per person, and $250 in property damages per occurrence.
7. Offer a choice of either (a) $100 deductible for damages by wind or hail (if the damage is between $100 and $500, the company will pay 125 percent of damages in excess of $100; company pays all for damages over $500; this is called a declining deductible) or (b) $100 to $500 deductible for all perils.
8. Offer a theft coverage extension endorsement covering personal property stolen from car or boat whether or not there were signs of forced entry.

D. There are six types of HO (homeowners policies):
1. HO 1 (basic) covers perils 1-11 (Table 6-3).
2. HO 2 (broad) covers perils 1 19 (Table 6-3).

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3. HO 3 (special) covers all risks except those specifically excluded such as war and vermin. It is the most popular and gives the broadest coverage at least cost.
4. HO 4 is for renters; covers perils 1–19 except for peril 12, window breakage. If, as a student, you are not covered by your parents' policy, you might want this.
5. HO 5 (comprehensive) covers all risks except exclusions and extends coverage to personal property as well as physical structures. The premium is about twice that of other policies.
6. HO 6 is designed for owners of condominiums against the same perils as HO 4. It covers unscheduled personal property and added living expenses.

E. There are two types of general property floater policies that cover personal property wherever you bring it against all perils except war, insects or vermin, radioactive contamination, and normal wear.

1. With a personal articles floater or schedule floater, each article or class of articles must be listed in the policy along with the conditions under which it is insured. Details are in Table 6-4.
2. A personal property floater protects all articles, scheduled or not, on a worldwide basis. It is seldom used because it is expensive.

F. Flood insurance is now available for flood-prone communities; rates are below expected losses because the insurance is subsidized by taxpayers.

G. Earthquake insurance is offered as a rider on a fire or HO policy. The standard deductible is 5 percent of the replacement cost of the home—usually large enough to cover losses due to minor earthquakes.

H. These clauses may be in your policy:

1. The *other insurance clause* limits the company's liability to that part of the loss equal to its share of total insurance coverage.
2. The *mortgagee clause* protects the mortgagee by promising to pay the amount of the mortgage in the event of loss of the property that secures the debt.
3. The *leasehold clause* covers a renter for damages to improvements the renter makes on the property.
4. The *apportionment clause* is similar to the other insurance clause and provides that the maximum extended fire coverage for any peril equals the ratio of that policy's coverage to the total amount of fire coverage on the property.

V. Costs of property insurance policies depend on what is covered, its value, and the perils insured against.

1. Premiums are based on two sets of data.
   a. The number of fires and extent of damage in a given area determines the basic fire rate.
   b. The number of thefts and extent of loss in a given area determines the theft rate.
   c. For other perils, data on the probability of their occurrence determines the premium.
2. Ways of lowering premium costs:
   a. Pay on a three-year basis, if possible.
   b. Increase the deductible.
   c. Live in an area where losses are low.
   d. Buy package policies.
   e. Take steps to minimize or avoid risks.
   f. Ask the insurance agent for rates before you move into a location.

SELF-TESTING EXERCISES

True-False

_____ 1. Land is not insurable.

_____ 2. Roughly 20 percent of the cost of a home is for the land on which it is built.

_____ 3. Trees and plants are not insurable.

_____ 4. Items that have a high risk of loss may be uninsurable.

_____ 5. Inventory sheets should be kept at home in your record file.

_____ 6. Construction costs usually closely approximate a house's market value.

_____ 7. HO 3 is the most popular of the homeowners policies.

_____ 8. The personal articles floater protects all articles, scheduled or not.

_____ 9. HO 4 is designed for renters.

_____ 10. HO 5 is designed for owners of condominiums.

Completion

1. The coinsurance clause requires you to insure up to __________ percent of the replacement cost of your home.
2. __________ value of an item is the dollar value you would realize if you sold it.
3. If you insure your personal property for replacement cost, you will be charged an extra __________ percent (usually) of the total premium.
4. Personal __________ floaters require that covered property be scheduled.
5. A deductible in an HO policy that varies with the size of the loss is called a __________ deductible.
6. To know what to insure, one should make a room-to-room __________.
7. The clause that covers a renter for damages to improvements the renter makes on the property is called the __________ clause.
8. HO 2 is also known as the __________ form.
9. Rates below expected losses and subsidized by taxpayers are applied to __________ insurance.
10. In earthquake insurance, the standard deductible is __________ percent of the replacement cost of the home.

Multiple Choice

1. If your home has a replacement cost of $50,000 and you carry two homeowners 3 policies on your home, each for $40,000, how much would each policy pay on a $10,000 loss?

   a. $10,000
   b. $8,000
   c. $5,000
   d. $4,000
   e. (None of the above)

2. If your home had a current replacement cost of $60,000, the standard deductible on your earthquake insurance coverage would deny any benefits up to the first

   a. $0
   b. $1,000
   c. $3,000
   d. $5,000
   e. $10,000

3. Which homeowners policy would you, as a student, do best to buy to protect your personal property while away at school?

   a. HO 1
   b. HO 2
   c. HO 3
   d. HO 4
   e. (None of the above)

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4. Homeowners policies usually cover

   a. personal property
   b. trees, shrubs, and plants
   c. personal liability and medical expenses arising from personal liability suits
   d. additional living expenses
   e. (All of the above)

5. A homeowners 3 policy covers

   a. personal property on and off the premises
   b. the dwelling
   c. attached structures
   d. trees, shrubs, and plants
   e. (All of the above)

6. If your five-year-old sofa cost $300 but would cost $500 if bought today, and is considered to have a 10-year life, how much would your personal property insurance pay, assuming you did *not* carry the replacement cost endorsement?

   a. $250
   b. $300
   c. $400
   d. $500

7. If the replacement value of your home is $50,000 and you carry $20,000 worth of insurance, how much will your policy pay if the home is completely destroyed and you chose the replacement cost valuation?

   a. $7,500
   b. $15,000
   c. $20,000
   d. $40,000

8. If the replacement value of your home is $50,000 and you carry $20,000 worth of insurance, how much will your policy pay on a $10,000 loss if you chose the replacement valuation?

   a. $5,000
   b. $6,000
   c. $8,000
   d. $10,000

9. If your home's replacement value is $60,000 and you carry $50,000 worth of insurance, how much will your policy pay on a $10,000 loss if you claim the replacement valuation?

   a. $8,000
   b. $8,500
   c. $9,000
   d. $10,000

10. To determine your property insurance requirements, you must determine

   a. which property you want to insure
   b. your property's value
   c. what to insure your property against
   d. the cost of the coverage
   e. (All of the above)

Cases and Problems

1. Pat and Doug insured their 2,000-square-foot home for its replacement cost of $60,000 five years ago. Today construction costs in their city are $42 per square foot.

   a. If Pat and Doug want to insure the total replacement cost of their home, how much insurance should they have?

   b. Because of the coinsurance clause, what minimum coverage do they need for 100 percent coverage of losses up to the insured amounts?

   c. If they incur a $10,000 loss while still insured for $60,000, how much will their policy pay?

2. Sue is a college student living in an off-campus apartment. She has lots of clothes, a stereo, a calculator, and several appliances.
   a. How can she determine her insurance needs?
   b. How might she prepare to substantiate a claim in case she suffers a loss?
3. Dick and Alice bought a homeowners 3 policy on their $60,000 home. They want to know their amounts of coverage for detached buildings; trees, shrubs, and plants; personal property on and off the premises; and added living expenses. Tell them the extent of their coverage of each.
4. Paula and Leon bought a new 2,000-square-foot home and brought to their new home the following items:

Item	Replacement Cost
a new king-sized bed	$500
a 4-year-old bureau (wood)	500
a 3-year-old stereo	600
two 10-year-old chairs	50 each
a 3-year-old wooden dinette set	300
a 5-year-old metal bookcase	70

   a. What kind of policy should they buy?
   b. Assuming all personal property above was destroyed by fire, what would be the difference in claims payment between valuing their property at market value as opposed to replacement cost?
   c. Assuming construction costs in their area were $40 per square foot, how much should their home insurance be?
   d. How much of this would apply to their personal property?

PERSONAL MONEY MANAGEMENT ACTIVITIES

1. Talk to an agent about personal articles floaters for your high-valued items of personal property.
2. Make a room-by-room inventory of your belongings, taking pictures from opposite ends of each room. Keep the inventory and pictures in a safe-deposit box.
3. Assess your personal insurance situation and call three insurance agents for rates on the type and amount of insurance you choose. Ask the agents why there are differences, if any, in their rates.

ADDITIONAL ACTIVITIES

Read the sample HO 3 policy provided at the end of the previous chapter. Notice the coverage provisions. The peril coverage described in the fewest words is the most comprehensive. The long paragraphs describing some perils define restrictions to the coverage.

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PERSONAL PROPERTY INVENTORY

1 Article Category	2 Number of Articles	3 Total Original Cost	4 Average Age (Years)	5 Annual Depreciation	6 Total Depreciation	7 Today's Cost	8 Accumulated Dollar Depreciation	9 Market Value
TOTAL								

SHOPPING FOR PROPERTY INSURANCE

		Insurer 1	*Insurer 2*	*Insurer 3*
Policy type				
Company				
Renewal date				
	Limits	*Premiums*		
Home				
Detached buildings				
Trees, shrubs, plants				
Personal property on premises				
Personal property off premises				
Additional living expenses				
Comprehensive personal liability[a]				
Medical expense payments[a]				
Scheduled items				
Endorsements				
Extended theft				
Inflation guard				
Replacement cost				
Other (e.g., earthquake, flood)				
Deductible				
Total annual premium				

[a] For explanation of these categories, see Chapter 7.

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7 · Comprehensive Liability and Auto Insurance

PERFORMANCE OBJECTIVES

After studying this chapter, you should be able to:

- Define negligence, absolute liability, and vicarious liability.
- Describe the three legal defenses possible in a liability suit, including the doctrine of comparative negligence.
- Decide how much liability insurance coverage you need, taking into consideration your liability exposure and your financial position.
- Describe the types of comprehensive liability insurance available and their provisions.
- Describe the types of automobile insurance available and their provisions.
- Choose appropriate auto coverages for you at the lowest costs.
- Explain what to do and not do if involved in an automobile accident.

OUTLINE OF THE MAIN IDEAS

I. Liability insurance protects against claims arising from bodily injury and property damage to others. Unlike property insurance, it pays money to others, not to you. Two kinds of liability insurance are discussed in this chapter: comprehensive insurance and automobile insurance.

  A. There are three types of liability.

    1. *Negligence* is failure to take that reasonable care a prudent person would take under like conditions to prevent injury to others and their property. In a suit, there must be proof that the injury resulted from this.
    2. *Absolute liability* is that which occurs when you are responsible for the conditions that lead to the injury, such as owning a dangerous dog.
    3. *Vicarious liability* applies when injuries occur to people in your employ from following your directions.

B. There are several defenses against liability.
  1. You can prove you used proper care.
  2. You can prove that the injured person voluntarily took the risk knowingly.
  3. You can prove contributory negligence, such as disregard of warning signs.
  4. Courts in some states cite *comparative* negligence, which holds that even if the injured party was somewhat at fault, that person should recover something.

C. You should determine your liability exposure before you buy insurance.
  1. *Liability exposure* is the total amount of money for which someone might sue you.
  2. It depends on your (and family's) activities and your financial visibility.
  3. Analyze your activities that could cause bodily injury or damage to others and eliminate or guard against them.
  4. There are basically three or four phases of exposure. Each has different insurance needs.
    a. When you are under 21 and covered by your parents' insurance
    b. When you buy your first house
    c. When your net worth is $25,000–$100,000
    d. When your net worth is over $100,000
  5. There are several methods for determining the amount of coverage.
    a. Using the *life value method,* you consider the sum of your net worth plus your annual salary times the number of years you expect to earn it, and insure for that amount.
    b. Using the *net worth method,* you assume you will not be sued for future income and insure for your net worth only.
    c. Using the *jury awards method,* you insure for enough to cover the maximum jury awards in your area.

II. There are two types of *comprehensive liability* insurance: general and umbrella.

A. *General liability* policies cover a variety of situations in the home and away from it. They do not cover slander, libel, or auto liability.
  1. General liability policies have *jacket provisions* so that the insurance company will make supplementary payments on your behalf if you are sued.
    a. The company has the right to inspect your property.
    b. You must notify the company in writing of events that might lead to a claim.
    c. If there are two or more policies, each insurance company pays only its proportional share.
  2. General liability policies protect both your family and others.
    a. They cover family and relations living with you and anyone under 21 in your care.
    b. They cover bodily injury and property damage incurred by visitors, guests, resident employees, or tradespeople.
      (1) From acts of members of your household
      (2) From acts of animals
      (3) From use of specified recreational equipment
  3. General liability policies do not cover business activities, intentional injury or damage, or cases covered under Workmen's Compensation.

B. *Umbrella* policies cover the same areas as general liability policies but extend coverage to include personal injury, such as slander and libel. They are also known as personal catastrophe insurance.

III. Automobile insurance consists of liability coverage and physical damage coverage.

A. Liability coverage includes
  1. Bodily injury
  2. Property damage liability
  3. Uninsured motorist
  4. Medical expenses

B. Physical damage coverage includes
  1. Comprehensive
  2. Collision

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C. Automobile insurance provides the same basic jacket provisions as liability insurance, but also has a cancellation clause giving the insurance company the right to cancel for various reasons.
   1. For any reason during the first 60 days
   2. With 30 days' notice if the insured or a member of the household incurs
      a. Suspension of driver's license
      b. A heart attack or epilepsy
      c. Three traffic violations within 18 months
      d. A conviction for felony, criminal negligence, or drunk driving

D. Unlike other liability coverage, automobile insurance offers physical damage coverage like property insurance. There are four basic types of coverage.
   1. *Bodily injury and property damage* coverage protects anyone who claims your home as a primary residence or anyone who drives your car with your permission.
      a. Liability limits are stated on a per individual and per accident basis. $15,000/$30,000 is common.
      b. Liability laws vary from state to state, but most states have financial responsibility laws requiring that drivers either post a bond or purchase automobile liability insurance.
      c. Property damage coverage protects the other party's car and personal property. It is usually $5,000, $10,000, or $25,000 per accident.
   2. *Uninsured motorist* coverage pays you what an uninsured motorist would have to pay if he were insured.
      a. It covers losses from hit-and-run drivers.
      b. It usually pays only for bodily injury, not for damage to your car.
   3. *Medical expense* coverage includes reasonable medical expenses incurred within one year from the date of an accident to anyone in your car who is injured.
      a. It also covers any member of your household injured as a pedestrian.
      b. Normal limits are $1,000, $2,000, or $5,000 per person.
   4. *Physical damage* coverage provides for repairs and replacement of your car and its equipment and contents. There are two major options.
      a. *Comprehensive* coverage is for loss by theft or larceny, explosion, earthquake, falling missiles, water, flood, vandalism, malicious mischief, riot, or civil commotion. It also insures the contents and (in some states) the car from fire and lightning.
      b. *Collision* coverage is separate from comprehensive since the probability of collision is greater. It covers impact with an object, another vehicle, or the ground, regardless of who was at fault.

E. You should relate each of these coverages to your needs.
   1. Bodily injury coverage is the most important to have, since it protects you against very large losses.
   2. Property damage coverage should also be kept high, since one accident can cause thousands of dollars worth of damage.
   3. Remember that you must pay for damages to your car caused by uninsured motorists. Drivers who do not have auto insurance often cannot afford to repair your car.
   4. If you have adequate medical coverage with health insurance or by some other means, and if laws of your state allow, you may consider medical coverage superfluous.
   5. The amount of physical damage coverage you should carry depends on the market value of your car. Premiums are high but can be reduced somewhat by increasing your deductible.
   6. You may also need separate insurance for your leisure vehicles—motor home, dune buggy, golf cart, etc. These special liability policies can also include coverage for additional living expenses and miscellaneous personal property.

F. Auto insurance rates are based on the insurance company's recent records of claims in a given locality.
   1. Rates are doubling every ten years.
   2. Rates are lower for those with good driving records (see Tables 7-5 through 7-7 in the text).
   3. If insurance companies will not insure you, you can still buy insurance through state-regulated assigned-risk pools.

4. There are various ways to keep your rates low.
    a. If you qualify as a "safe driver," if you are an underage driver and are away at school or in the service, or if you have grades of B or better, you may get a discount.
    b. If you drive a smaller car or drive less than 6,500 miles per year, or if your car is used primarily on a farm or ranch, rates for liability and collision may be reduced.
    c. Shop around. Rates vary from company to company (see Table 7-8).

G. There are several things to keep in mind if you have an auto accident.
  1. Request a copy of the police report.
  2. Write down all details—names, drivers' license numbers, etc.
  3. Try tactfully to obtain witnesses.
  4. Notify your insurance company.
  5. If the accident is not your fault, you will probably file a claim with the other party's claims adjuster.
    a. The claims adjuster estimates your total medical expenses and other losses due to your medical condition and the accident. After this, he or she applies the "pain and suffering" multiplier (usually 3) to the total of all the expenses and adds the product to the total expense.
    b. Do not discuss your medical history or the accident with the adjuster, and do not sign anything.
    c. File your claim only when you know what all the expenses will be but within one year of the date of the accident.
    d. Remember, endorsing the settlement check releases the insurance company from future liability.

H. No-fault insurance reimburses medical expense and income loss regardless of fault. There is no settlement process. Since it reduces costs, it is usually favored by insurance companies but opposed by some who feel it takes away legal rights to justice and compensation from the wrongdoer.

SELF-TESTING EXERCISES

True-False

_____ 1. Two-thirds of civil liability suits involve claims due to damage from autos.

_____ 2. Liability insurance makes payments to the insured rather than to the person whom the judgment favored.

_____ 3. General liability policies do not cover claims arising from business activities.

_____ 4. General liability policies cover personal injury, such as slander or libel.

_____ 5. The cost of a $1 million umbrella policy ranges from $60 to $80 in most states.

_____ 6. You are liable for negligence when you are directly responsible for the conditions leading to the injury of others, such as letting a vicious dog run free.

_____ 7. The sum of your net worth plus your annual salary times the number of years you expect to earn it is called the net worth method of determining the amount of liability coverage you should carry.

_____ 8. An auto insurance company can cancel a policy within 30 days if the insured has three traffic violations within 12 months.

_____ 9. Uninsured motorist coverage pays only for bodily injury, not for damages done to your car.

_____ 10. The basic premium for collision insurance is about the same as that for comprehensive.

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Completion

1. Failure to take reasonable care to prevent injury to others or their property that a prudent person would take is called ____________________.
2. There are ____________________ phases of liability exposure that you might incur at various times in your life.
3. Policies that extend liability coverage to include personal injury, such as slander and libel, are called ____________________ policies.
4. In auto insurance, there are two types of coverage for physical damages. One is comprehensive and the other is ____________________.
5. If you drive your car less than ____________________ miles per year, you may receive a discount on your premium.
6. The multiplier for pain and suffering is usually ____________________ times the amount of the total of medical and other expenses.
7. Since the premiums are so expensive and your car's value depreciates each year, you might retain ____________________ risks.
8. ____________________ insurance makes pain and suffering payments only to permanently impaired people.
9. Cars with more powerful engines have premiums that may be ____________________ percent higher than normal.
10. Liability claims from ____________________ insurance are greater than those arising from other types of liability insurance.

Multiple Choice

1. General liability policies do NOT cover

   a. business activities
   b. intentional injury or damage
   c. workers' compensation cases
   d. (All of the above)

2. If your medical expenses are $2,000, your loss of income $1,000, and miscellaneous expenses $500, what will the claims adjuster determine the size of your total claim to be?

   a. $3,500
   b. $10,500
   c. $14,000
   d. (None of the above)

3. Your insurance company may refuse to honor your claim if you do not report an accident in which you were involved normally within

   a. 24 hours
   b. 48 hours
   c. 1 month
   d. 1 year

4. Which information is NOT important to obtain if you are involved in an auto accident?

   a. License plate number
   b. Social Security number
   c. Insurance company name
   d. Make of car

5. To estimate the size of your insurance claim, the claims adjuster estimates which of the following?

   a. Any loss of income
   b. Medical expenses
   c. Miscellaneous expenses
   d. Pain and suffering
   e. (All of the above)

6. A limit of 100/300 refers to which type of auto coverage?
   - a. Comprehensive physical damage
   - b. Medical expense
   - c. Bodily injury liability
   - d. Property damage liability

7. Which of the following may result in lower auto insurance premiums?
   - a. Low horsepower car
   - b. No teenage drivers
   - c. Good school grades
   - d. Driver education
   - e. (All of the above)

8. The annual cost for an average umbrella policy is about
   - a. $10
   - b. $40
   - c. $70
   - d. $150

9. If your net worth is under $25,000 and you are married, in which phase of liability exposure do you find yourself?
   - a. Phase I
   - b. Phase II
   - c. Phase III
   - d. Phase IV

10. If the injured party in a general liability claim behaved in a negligent way, under which type of liability defense may you find a legal defense?
    - a. The proper degree of care doctrine
    - b. Contributory negligence
    - c. Assumption of risk
    - d. (None of the above)

Cases and Problems

1. John was hospitalized because of a car accident caused by an insured person. He could not work for a month and lost his $1,800 salary. Hospital expenses amounted to $200 per day for eight days. Also, his golf clubs ($300) and his sample case ($400) were destroyed. How much would he be offered by the claims adjuster?

2. Jill has a five-year-old car worth $890. Her collision premium is $300 per year with a $100 deductible. Her average annual loss due to collision is $120, and she has $2,000 in her savings account. Advise Jill as to her collision insurance.

3. Jane and Jim have been married 15 years and have two children, ages 14 and 12. Jim earns an average of $40,000 a year as a lawyer; Jane, a programmer, has an annual salary of $22,000. Their present net worth is $180,000. They have a homeowners policy with $100,000 of liability coverage.
   - a. In what phase of the liability cycle are they now?
   - b. Should they change their liability coverage?
   - c. What change would you suggest? About how much more would it cost?

4. Judy asked her agent for rates for auto liability insurance and received this information:

   Bodily injury 50/100—$40; 100/300—$60; 250/500—$80

   Property damage $5,000—$20; $10,000—$25; $25,000—$30

   Medical expense $1,000—$6; $2,500—$8; $5,000—$10

   - a. Which coverages would you advise for Judy?
   - b. What would be the total costs of the recommended coverage, assuming she qualifies for a safe driver reduction of 20 percent?

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PERSONAL MONEY MANAGEMENT ACTIVITIES

1. Research quotes on collision coverage for compacts, "hot cars," and foreign cars.
2. Check your own policy to determine whether you are covered adequately at least cost.

ADDITIONAL ACTIVITIES

1. Talk to a Highway Patrol officer or local police officer and ask how to report an accident. Discuss what is included in an accident report.
2. Write your local state legislators and ask them to report to you on the progress of no-fault legislation in your state.
3. Talk with a claims adjuster and a personal liability attorney and compare their attitudes and points of view toward things such as individual liberties, no-fault insurance, and the impersonality of the insurance industry.

SHOPPING FOR AUTO INSURANCE

			Insurer 1	*Insurer 2*	*Insurer 3*
Company					
Renewal date					
	Limits		*Premium*[a]		
	Car 1	*Car 2*			
Public liability					
Bodily injury					
Property damage					
Medical expenses (no fault)					
Uninsured motorist protection					
Physical damage					
Comprehensive					
Deductible					
Collision					
Deductible					
Total annual premium					

[a] Total premium for coverage area, regardless of number of cars.

8 · Health Insurance

PERFORMANCE OBJECTIVES

After studying this chapter, you should be able to:

- Determine what your needs for medical expense coverage and for income would be if you were to become sick or disabled.
- Select appropriate deductibles, major medical maximums, coinsurance features, and waiting periods for the policies you would purchase.
- Describe the benefits to which you may already be entitled through employee group programs, Social Security, workers' compensation, and state disability insurance programs.
- Explain the disadvantages of buying double indemnity types of insurance such as aviation ticket policies and accidental death and dismemberment coverage.
- List and describe the various outlets for medical insurance.

OUTLINE OF THE MAIN IDEAS

I. Health insurance is the most important type of insurance you can have, because sickness and disability can cause loss of your income.

II. There are several factors to consider in determining your medical expense needs.
   A. They cannot be accurately predicted, but you can identify the types of expenses you might incur.
   B. You should study your balance sheet and then self-insure with deductibles as much as you can, buying greater coverage with the premium dollars saved.
   C. Distinguish between true insurance plans, prepayment plans, and indemnity plans.
      1. True insurance involves paying a small premium for benefits that may possibly exceed the amount of the premiums.
      2. Prepayment insurance gives you coverage for a guaranteed event, but is actually more expensive than paying for the event (such as an annual physical).
      3. Indemnity plans often have hidden restrictions and do not pay for medical expenses that do not involve hospitalization.

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III. There are five types of medical expense coverage. Table 8-2 outlines the major features of each.
  A. Hospital expense insurance includes room and board, extra services, and maternity and nursing charges.
  B. Surgical expense insurance includes the surgeons' and the anesthesiologist's fees.
  C. General medical expense insurance covers the doctor's fee plus routine items, up to a specified dollar limit.
  D. Major medical insurance covers a fixed percentage of nearly all types of medical care and equipment. It usually has an upper limit and a deductible, and may include a coinsurance feature that requires the insured to pay a certain percentage.
  E. Comprehensive medical expense insurance is similar to major medical, but has a lower (or no) deductible.

IV. You should determine your disability income needs.
  A. Determine your present annual living expenses from your income statement, and adjust those that would be affected if you became disabled.
  B. Estimate what your income would be: from your spouse's employment, your investments, Social Security, or other sources. Insure for the difference. You may want to buy a policy with automatic benefit increases over time or estimate the effect of inflation over your life expectancy and buy a policy for that amount.

V. Disability insurance helps you absorb a loss of income.
  A. Self-insure yourself by buying a policy with waiting periods. Use your emergency fund and sick leave benefits to determine how long your waiting period can be.
  B. There are several kinds of disability coverage.
    1. One type provides payments as long as policyholder is unable to perform any or all functions of his or her occupation.
    2. Another provides payments only if the policyholder can perform no gainful employment at all.
    3. A residual policy provides payments based on the ratio of the disability benefit to the person's salary and thus motivates the disabled to return to work.
    4. If disability occurs through accident, payments may be for life; if through illness, payments may be made only to age 65.
    5. Some disability income policies discriminate against women in terms of years of coverage and amount of payments.
    6. *Basic contracts* (commercial contracts) are the most popular type of disability coverage. They may be for total or partial disability through accident or illness and may cover you to age 65, or may cover your lifetime if you are totally disabled because of an accident. These contracts may contain various clauses.
      a. *Presumptive disability* clauses define conditions considered disabling.
      b. *Double indemnity* clauses provide twice the normal payment for specified disabilities from accident.
      c. *Prorating* clauses are provisions for altering the cost of your insurance.
    7. You may add a *disability income rider* to your life insurance policy. These generally offer an income of $10 per month per $1,000 of insurance.
    8. *Limited contracts* impose restrictions and exclusions beyond those in basic contracts. The most common limitations are types of accident or disease covered and the length of the coverage period.
    9. *Industrial policies* are similar to basic contracts but usually offer less protection and a longer waiting period. Small weekly payments make such policies desirable to persons with low incomes or poor savings habits.

VI. Social Security also provides disability, hospitalization, and health expense benefits.
  A. Disability benefits are payable at any age.
  B. Hospitalization benefits are automatic if you are 65 or over.
  C. Medical expense benefits (Medicare benefits) are optional. To qualify you must be 65 or have been disabled for a certain time. You pay a yearly deductible and Medicare pays 80 percent of your expenses after that.

VII. Workers' compensation covers accidents and illness arising from your employment. Plans vary from state to state, but funds are provided by employers.

VIII. Group insurance plans may also be provided by employers for employees and their families. They may offer five types of group insurance.
  A. *Health expense coverage* may be offered to all employees. Be sure you know both the major medical maximum and the amount of deductible required.
  B. *Short-term disability* benefits take the form of sick leave.
  C. *Long-term disability* plans are usually coordinated with Social Security and workers' compensation plans.
  D. *Accidental death and dismemberment* is usually voluntary.
  E. Varying amounts of *dental insurance* may also be offered.
  F. When both spouses work for different firms, be sure to select the most cost-effective coverages. Be aware of participation limits that state the maximum amount that can be received from all sources or you may be paying for benefits you can never collect.

IX. There are three other major sources of medical insurance coverage.
  A. Blue Cross offers hospitalization and Blue Shield offers general medical coverage.
  B. Health maintenance organizations (HMOs or independent associations) render treatment in return for a fixed fee.
  C. Commercial insurance companies can write specialized policies for individual needs.
  D. National health insurance, if enacted, would provide health care and insurance to persons under 65.

X. There are four major cost considerations to keep in mind when shopping for health insurance.
  A. The amount of deductible
  B. Length of term of coverage
  C. Type and amount of coverage
  D. Renewability provisions

SELF-TESTING EXERCISES

True-False

_____ 1. Health insurance is more important than auto insurance.

_____ 2. Medical expense needs can be predicted accurately.

_____ 3. The broad definition of disability is that the person is unable to perform any or all of the functions of his or her occupation.

_____ 4. Some disability income policies discriminate against women.

_____ 5. Industrial policies are the least costly type of disability policy.

_____ 6. There must be disability in the strict sense to be eligible for Social Security disability benefits.

_____ 7. Under Medicare, there is no deductible and Medicare pays 70 percent of expenses.

_____ 8. Long-term disability group plans have waiting periods varying from 1 to 24 months.

_____ 9. When both spouses have group family health insurance from their employers, it is economical for both spouses to buy it.

_____ 10. Because disability needs vary with the cause of the disability, double indemnity policies are advisable.

Completion

1. The ______________________ in disability insurance is a deductible of time rather than money.

2. A policy that motivates the disabled toward gainful employment is called a ______________________ policy.

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3. The ____________________ clause defines conditions that are considered disabling.

4. Disability income ____________________ may be attached to your life insurance policies.

5. The medical expense coverage of Social Security is called ____________________.

6. ____________________ is state controlled and its funds are provided by employers.

7. In ____________________ insurance, payments to the insured are small per premium dollar because of the high costs of collecting premiums.

8. Maximum benefits for ____________________ insurance are normally two-thirds of one's salary.

9. There are three types of dental insurance: basic, comprehensive, and a ____________________ of these.

10. ____________________ insurance plans can be more expensive than no insurance at all.

Multiple Choice

1. Bill had the choice of three disability policies: $1,000/month disability benefit with a 30-day waiting period costing $526/year; $1,000/month benefit with a 90-day waiting period costing $383/year; and $1,000/month benefit with a 180-day waiting period costing $250 per year. Bill figured $1,000 per month was an adequate benefit but did not know what waiting period he should choose. He had a sum of $3,500 in his emergency reserve. Which policy should Bill select?

   a. 30-day waiting period
   b. 90-day waiting period
   c. 180-day waiting period
   d. (None of the above)

2. If Jen had a major medical policy that paid 80 percent of the first $2,500 expenses above a $500 deductible and 100 percent of all expenses above $2,500, how much would she have to pay if she incurred $5,000 worth of covered medical expenses?

   a. $500
   b. $1,000
   c. $2,000
   d. $2,500
   e. $3,500

3. The longer the waiting period on a disability contract,

   a. the lower the premium
   b. the higher the monthly benefit
   c. the longer the policy term
   d. the broader the definition of disability
   e. (None of the above)

4. Group insurance plans often offer which of the following benefits?

   a. Medical expense coverage
   b. Short-term disability
   c. Long-term disability
   d. Accident and dismemberment
   e. (All of the above)

5. Health maintenance organizations (HMOs) are examples of which type of insurers?

   a. Independent health associations
   b. Commercial insurance companies
   c. Blue Cross/Blue Shield
   d. Group employer insurance plans
   e. (None of the above)

6. The type of medical expense coverage that pays the charges of an anesthesiologist is

   a. hospital expense coverage
   b. general medical expense
   c. basic contract
   d. surgical expense

7. If you work now, or have ever worked, and are under age 65, you may be entitled to medical and disability benefits under

   a. Medicare
   b. life insurance riders
   c. Social Security
   d. dental plans

8. Which of the following does NOT affect the cost of premiums for health insurance?

   a. Age
   b. Marital status
   c. Renewability provision
   d. Dental plans

9. Higher deductibles mean lower premiums because

   a. the insurance company has to pay less money in claims
   b. the insurance company avoids the bookkeeping and record keeping expenses attributable to small claims
   c. the majority of claims submitted to insurance companies are small
   d. insurance companies want to motivate the insurance buyer to self-insure a portion of any loss
   e. (All of the above)

10. Hospital expense coverages usually include

   a. room and board
   b. maternity charges
   c. nursing charges
   d. extra hospital charges
   e. (All of the above)

Cases and Problems

1. Ann and Peter's annual living expenses were $23,000 last year out of which they were paying $1,300 for waiver of premium life and health policies. Ann's annual salary is $18,000 and Peter's is $15,000. Last year's taxes amounted to $3,200 on Ann's salary and $2,800 on Peter's. Their investments of $7,000 are yielding 8 percent. Ann is 25 years old and Peter is 27. Ann does not qualify for Social Security. Using the step-by-step procedure, determine Ann's annual disability income needs.

2. Jay and Kathy are in the market for a medical insurance policy. Their insurance agent has suggested the following choices:

   a. hospital expense policy providing $60/day for room and board for a maximum of 180 days and a maximum of $1,500 per calendar year for hospital extras; costs $450 a year ($100 deductible)

   b. surgical expense policy with a $750 surgical maximum; costs $412 a year ($50 deductible)

   c. major medical policy with a $35,000 lifetime maximum; costs $500 a year ($500 deductible)

   Jay and Kathy have an emergency reserve of $4,200. What would each policy pay if Jay were in an auto accident that caused him to have surgery ($1,200), confined him to the hospital for six days (at $125/day), and cost $1,200 in hospital extras? Which policy would you recommend that Jay and Kathy buy?

3. Having fallen and injured a vertebra, Luke must stay in bed for nine months. His accumulated sick leave entitles him to one month's salary ($1,200). He has a disability insurance policy that will pay him two-thirds of his salary for two years after a six-month waiting period. Luke and his wife's living expenses are $1,000 a month.

   a. How much should Luke receive from his disability policy over the nine-month period?

   b. How much does he need from his emergency fund?

   c. What are his total disability benefits?

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4. Tim Shine, a bachelor, was 45 years old in 1980 with 20 years of work experience behind him. He had consistently earned over $12,000 for the last 18 years. If he were totally disabled at the end of 1980, approximately how much in monthly benefits would Tim start receiving from Social Security? (Follow the procedure in the Social Security addendum in the text.)

PERSONAL MONEY MANAGEMENT ACTIVITIES

1. Check with your school, employer, or parents to find out what benefits you might receive in terms of medical expense coverage. What kind of policy do you have? What is the deductible? Is it a *per cause* or *calendar year* deductible? What is the maximum benefits provision? If it is a major medical, what is the coinsurance provision? What are the exclusions?
2. What coverages do you need to consider buying for yourself? How much are your needs?

ADDITIONAL ACTIVITIES

1. Call an insurance agent and ask how much in benefits a premium of $200 per year would buy for a hospital expense policy, a surgical expense policy, and a major medical policy. Notice what the deductible would be for each type of coverage. Also notice what happens when you raise the deductible in terms of the total benefits you might receive. Use the grid below to score your results.

	What $200/Year Can Buy			
Deductible	$100	$200	$500	$1,000
Policy type				
Hospital Expense				
Surgical Expense				
Major Medical				

2. Review the "definition of disability" clauses provided below. Which clause covers a residual policy? Which is for own occupation coverage? Which is a strict Social Security-type definition of disability? Notice the difference in the language in the clause.

   A. "Own Occupation" Disability Clause

   Total disability means that as a result of injury or sickness, the insured is completely unable to engage in his or her regular occupation; however, after monthly indemnity has been payable during any continuous period of disability to the insured's fifty-fifth birthday or for a period of sixty months, whichever is the longer, then during the remainder, if any, of the period for which monthly indemnity is payable. *Total disability* shall mean complete inability of the insured as a result of such injury or sickness to engage in any gainful occupation for which the insured is reasonably fitted by education, training or experience, giving due consideration to his or her economic status at the beginning of disability.

   B. "Residual" Disability Clause

   Total disability means that as a result of such injury or sickness the insured is unable to perform the duties of his or her regular occupation and is not engaged in any other gainful occupation. *Partial disability* means that as a result of such injury or sickness, the insured is unable to perform the duties of his or her regular occupation but (1) is able to perform one or more of the important duties of that occupation and is earning an income from that occupation but in a reduced amount as a result of such injury or sickness, or (2) is engaged in another occupation; provided, however, such partial disability must result in a continuous reduction of 20 percent or more of the insured's monthly earned income prior to disability. *Monthly earned income prior to disability* means the greater of (1) the average monthly earned income of the insured during the six calendar months immediately preceding the time disability commenced, or (2) his highest average monthly earned income for any two consecutive years in the five-year period immediately preceding the disability for which claim is made. The term *Monthly earned income* shall not include: (1) any income received from any pension, deferred profit sharing, annuity, or deferred compensation plan, nor (2) any investment income, rent, royalties, income from governmental plans, or any other income not derived directly from the insured's vocational activities, nor (3) any income that is deductible from gross income as a business expense for federal income tax purposes. *Presumptive total disability* means that as a result of such injury or sickness, the insured sustains the entire and irrecoverable loss of speech or hearing or sight of both eyes, or the irrecoverable loss of use of both hands or both feet, or the irrecoverable loss of use of one hand and one foot.

3. Review the excerpts from a sample major medical policy on pages 70–73. Note that this is a group insurance plan.

NAME ____________________

DATE ____________________

STATEMENT OF INCOME DISABILITY NEEDS

1 *Annual Living Expenses* ________

2 *Adjusted Annual Living Expenses*

Tax savings ________

Insurance premiums waived ________

Other ____________ ________

3 *Spouse's Income* ________

4 *Investment Income* ________

5 *Social Security Benefits* ________

6 *TOTAL ADJUSTMENTS* ________

7 *Net Annual Disability Income Needs* ________

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SHOPPING FOR HEALTH INSURANCE

	Insurer 1	*Insurer 2*	*Insurer 3*
Medical Expense Coverage			
Company	__________	__________	__________
Limits	__________	__________	__________
Room and board	$__________	$__________	$__________
Surgical maximum	$__________	$__________	$__________
Hospital extras	$__________	$__________	$__________
Physician care	$__________	$__________	$__________
Major medical maximum	$__________	$__________	$__________
Deductible	$__________	$__________	$__________
Reinstatement provisions	__________	__________	__________
Annual premium	$__________	$__________	$__________

Disability Income Coverage			
Company	__________	__________	__________
Monthly benefits			
Total disability	$__________	$__________	$__________
Partial disability	$__________	$__________	$__________
Maximum age			
Accident	__________	__________	__________
Illness	__________	__________	__________
Waiting period	__________	__________	__________
Annual premium	$__________	$__________	$__________

SCHEDULE OF INSURANCE

MAJOR MEDICAL EXPENSE BENEFITS

If this coverage is specified in your Employer's Participation Agreement, the major Medical Expense Benefit shall be:

TYPE A HOSPITAL EXPENSES

For semi-private hospital room and board, other hospital charges, surgery, and in-hospital physician's calls prior to surgery, in-hospital physician's calls for non-surgical medical care, and expenses as a direct result of an accidental injury.

TYPE B NON-HOSPITAL EXPENSES

All other covered expenses, after a $100 Deductible per person per calendar year. Maximum deductible per family is $250 per year.

MAJOR MEDICAL EXPENSE INSURANCE
FOR EMPLOYEES AND DEPENDENTS

Major Medical Expense insurance pays benefits as described below. Medical expenses incurred are paid according to the Schedule of Insurance to the extent such expenses are reasonable and customary and performed or prescribed by a duly licensed physician or surgeon. Covered medical expenses are of two types: Type A — Hospital, and Type B — Non-Hospital.

The plan will pay, for Type A and B expenses incurred during each calendar year,

80% of the first $ 2,000
90% of the next $ 5,000
110% of the next $10,000
and 100% of the excess* subject to a
$1,000,000 lifetime maximum benefit
per covered individual.

*Should an individual in your family have $7,000 or more of covered expenses in a calendar year, then 110% and 100% benefits shall apply to all expenses only during the next calendar year whether from the same or other causes. The deductible and coinsurance must be resatisfied during the third calendar year.

MAJOR MEDICAL HOSPITAL EXPENSE INSURANCE (TYPE A)

For you and your dependents (if dependents insurance is included and specified in this Certificate of Insurance).

BENEFITS FOR TYPE A COVERED EXPENSES

Benefits are payable according to the Schedule of Insurance for those Type A expenses described below, which are incurred during any one calendar year. Reimbursement for Type A expenses shall not exceed the total expenses incurred.

TYPE A COVERED MEDICAL EXPENSES

(1) Expenses of room and board accommodations in a hospital up to the hospital's semi-private room rate. Charges for private room and board are covered to the extent of the hospital's most common semi-private room rate.
(2) Expenses of services or supplies furnished in connection with hospital confinement including:
  (a) pre-admission testing within 10 days of admission,
  (b) charges for blood and blood plasma to the extent not covered by blood donations,
  (c) anesthetics and their administration,
  (d) operating room charges,
  (e) local ambulance service, involving an accidental injury, or hospital confinement,
  (f) X-rays and other diagnostic procedures,
  (g) drugs, medicines and dressings.
(3) Surgery performed by a surgeon or assistant surgeon, surgery to include childbirth and its complications, subject to a determination of reasonable & customary charges for a like surgical procedure.
(4) In-hospital physician's visits prior to surgery and in-hospital physician's visits for non-surgical medical care.
(5) Intensive care unit charges when prescribed by a physician.
(6) Expenses as a direct result of an accidental injury incurrod while insured under this plan provided such expenses are incurred within 90 days from the date of the accident.
(7) Expenses incurred in Ambulatory Surgical Centers, to the extent such expenses would have been covered had treatment been rendered as a hospital in-patient.

MAJOR MEDICAL NON-HOSPITAL EXPENSES INSURANCE (TYPE B)

For Employees and dependents (if dependents insurance is included and specified in this Certificate of Insurance).

BENEFITS FOR TYPE B COVERED EXPENSES

Benefits are payable according to the Schedule of Insurance for those Type B expenses described below, which are incurred during any one calendar year, subject to an initial deductible of $100 of covered expenses per individual, or $250 per family.

TYPE B COVERED MEDICAL EXPENSES

(1) Services of physicians including specialists other than for services covered under Type A expenses.
(2) Charges for preventive care such as immunization, physical examinations.
(3) Private-duty nursing in-hospital or elsewhere by a registered graduate nurse (R.N.), and private-duty nursing service by a registered or licensed practical nurse, or licensed vocational nurse (LVN) in-hospital if the attending physician certifies that a registered graduate nurse is not available. In either case, the nurse is one who does not ordinarily reside in your home and is not a member of your immediate family (i.e. your wife or husband, children, brothers, sisters or parents).
(4) The following services and supplies provided while not in a hospital:
  (a) drugs and medicines obtainable only on a physician's prescription,
  (b) oxygen and its administration,
  (c) rental or purchase at the Insurer's option of iron lung, oxygen tent, hospital bed, wheel chair and similar durable medical equipment primarily used for therapeutic purposes,
  (d) blood and blood plasma and its administration to the extent not covered by donations,
  (e) braces, crutches, and prosthetic devices necessitated by disease or injury that commenced while insured under this coverage and their replacement necessitated by pathological change, but not including charges for repair or maintenance,
  (f) X-ray examination and laboratory tests,
  (g) physiotherapy,
  (h) local ambulance service where no accidental injury or hospital confinement is involved.

ACCIDENT EXPENSE BENEFIT (OPTIONAL)

This coverage applies only if selected by your Employer. If a covered person suffers an accidental bodily injury while insured and incurs covered medical expenses in treating those injuries, SAFECO Life will reimburse for those expenses at the rate of 100% of the reasonable and customary amount, without requiring that a deductible be satisfied. The expenses must be incurred while the person is insured and within 90 days from the date of the accident. SAFECO Life's reimbursement under this provision will not exceed $300 per person in each calendar year. Following payment of $300 in benefits under this provision, SAFECO Life's benefits will be paid as otherwise provided in the policy, and will be paid at the percentages and subject to the deductibles then in effect.

BENEFITS FOR EXPENSES DUE TO PREGNANCY

Expenses due to pregnancy or its complications are treated like any other covered medical expenses. If the optional maternity deductible is selected in the Employer's Participation Agreement, a $1,500 deductible applies to expenses due to normal pregnancy. In any event, benefits are payable only if the person is insured on the date the expenses are incurred.

THE CASH DEDUCTIBLE

(A) This insurance applies only to that portion of expenses incurred, as per List of Covered Items, which exceeds in any Calendar Year, an amount called the Cash Deductible prescribed in the Schedule of Insurance. For each Calendar Year there shall be a separate deductible for each covered person, except that any expenses incurred during the last three months of a Calendar Year, which are applied to reduce the deductible sum, will reduce the deductible sum in an equal amount for the Following Calendar Year.
(B) Charge for a covered expense shall be deemed to be incurred on the date the covered person received or is furnished the item or service for which the charge is made.

REINSTATEMENT OF AGGREGATE MAXIMUM BENEFIT: If benefits in an aggregate amount of $2,000 or more become payable for covered expenses incurred by a covered person, the applicable Aggregate Maximum Benefit may be reinstated by:

(1) Submitting evidence of insurability satisfactory to SAFECO Life. The Aggregate Maximum Benefit applicable on the date of approval of such evidence by SAFECO Life at its Home Office shall be reinstated, if you are otherwise eligible under this coverage on that date, provided,
  (a) in the case of you, an employee, that you are then actively at work with your Participating Employer, otherwise reinstatement shall be effective on the first date thereafter on which you are actively at work with your Participating Employer in the class of employees eligible for insurance under this coverage, and
  (b) in the case of your dependent, that your dependent is not then prevented by injury or disease from carrying on any substantial part of the regular and customary duties of a person of like age and sex, otherwise, reinstatement shall be effective on the date your dependent recovers and resumes substantially all of said duties, if your dependent is then eligible for insurance under this coverage, or
(2) Automatic reinstatement on the first day of each Calendar Year of an amount equal to the lesser of:
  (a) $2,000 or
  (b) the difference between the Aggregate Maximum Benefit shown in the Schedule of Insurance, and the unused portion of such Aggregate Maximum Benefit on the first day of each Calendar Year.

provided, however, that no automatic reinstatement of the Aggregate Maximum Benefit shall be made with respect to any person whose benefits are determined under the provisions of this Certificate of Insurance entitled, "Extension of Benefits", nor shall the automatic reinstatement provision apply to covered expenses for mental and nervous conditions which are limited to an overall lifetime maximum of $25,000.

EXTENSION OF BENEFITS FOR:

MAJOR MEDICAL HOSPITAL EXPENSE INSURANCE (TYPE A EXPENSES)

If a covered person is totally disabled as a result of covered injury or covered disease when the insurance under these coverages discontinued, and if the covered person becomes confined in a hospital and/or undergoes a surgical procedure, as a result of and during the continuance of that disability within 90 days, after the termination of insurance, the same benefits shall be payable for the hospital and/or surgical procedure charges incurred with that confinement and/or surgery which would have been payable, if the charges were incurred while insured.

MAJOR MEDICAL NON-HOSPITAL EXPENSE INSURANCE (TYPE B EXPENSES)

If a person is totally disabled as a result of a covered injury or of a covered disease when the insurance under this coverage is discontinued, and if the person incurs charges as a result of such injury or disease within one year after that date and during the continuance of that disability, the same benefit shall be payable for the charges so incurred which would have been payable if they had been incurred while the person was insured.

FAMILY SURVIVOR BENEFIT

This benefit provides that the Medical Care insurance in force for your dependents on the date of your death will remain in force without payment of premium until the earliest of the following dates:

(1) Remarriage of your surviving spouse, in which case the coverage for all dependents terminates;
(2) the date your dependent qualifies for Medicare (there is no continuance for your dependent who is already eligible for Medicare when you die);
(3) the date a covered person ceases to qualify as a dependent for any reason other than lack of primary support by you;
(4) one year from the date of your death.

The insurance which is continued in force for dependent children because of your death will not be affected if your surviving spouse dies during this continuation of coverage. The Extension of Benefits and the provisions for Accident and Health Conversion Privilege apply to dependents when the coverage provided by the Family Survivor Benefit terminates.

PROVISIONS WITH RESPECT TO MEDICARE

EMPLOYEE and/or DEPENDENT MEDICAL CARE COVERAGE

(A) If you or your dependent becomes eligible for the program of medical care benefits provided under Title XVIII of the Social Security Act of 1965, as amended (hereinafter referred to as "Medicare"), you are considered to be covered by both Medicare parts "A" and "B" for all purposes under this policy.
(B) You or your dependents are considered to be eligible for Medicare on the earliest date any coverage under Medicare could be effective, had they applied for Medicare in a timely manner.
(C) You or your dependents who are eligible for Medicare will not be excluded from coverage for yourself or your dependents solely due to Medicare eligibility.
(D) Medical benefits payable under this policy for you or your dependent shall be reduced by an amount equal to the amount of benefit they could receive from Medicare parts "A" and "B".

PROVISIONS for ACCIDENT and HEALTH CONVERSION

CONVERSION PRIVILEGE

(A) You or your dependent who is under age 65 and whose insurance under all Accident and Health (see definition in Definition Section) coverages under this Certificate of Insurance ceases solely because
  (1) your employment, for the purposes of insurance, is terminated, or
  (2) you or your dependent's classification changes to a class of employees or dependents which is ineligible for insurance under such coverages,

will be entitled to have issued by SAFECO Life, a personal health policy, provided:
  (a) the date your insurance ceased is not coincident with the date of termination of participation by your Employer under this Policy, or of termination of said Accident and Health insurance for all of the employees of a class of which you are a member, and
  (b) you are not otherwise eligible to be insured under this Policy for any coverage providing benefits similar in kind to those for which you were insured under this Certificate of Insurance when your insurance ceased.

(B) The personal health policy shall cover yourself, and shall also cover all your dependents whose insurance, under this Certificate of Insurance, ceased solely by reason of cessation of your insurance, and who are not otherwise eligible for similar insurance, under this Policy.
(C) Issue of the personal health policy will be subject to all of the following conditions:
  (1) No evidence of insurability will be required.
  (2) Written application for conversion and the first premium for the new policy must be delivered or mailed to SAFECO Life at its Home Office within 31 days after the date on which your Accident and Health Insurance ceased, as set forth in (1) or (2) of (A) above.
  (3) The form of the new policy, the benefits provided thereunder, the individuals covered, the amount of premium payable, and all other terms and conditions thereof, shall be such as are provided by the rules of SAFECO Life pertaining to individual policies available for conversion purposes at the time application for the personal health policy is received by SAFECO Life.
  (4) Insurance, under the new policy, will become effective on the date following the date on which insurance, under this Certificate of Insurance ceases.
(D) The benefit for hospital daily board and room for yourself or your dependent under the new personal health policy shall be elected by you at the time of conversion.
(E) Should you convert the insurance and again become eligible for insurance under this Policy, coverage will be allowed only after submission of evidence of insurability satisfactory to SAFECO Life.
(F) The conversion privilege, under this Policy, may be exercised only once.
(G) No personal health policy shall be issued to a person who is not a resident of the United States, Canada, Mexico, or to a person who has been covered under the Accident and Health Coverages of this Policy for less than 6 consecutive months.

COORDINATION OF BENEFITS

BENEFITS SUBJECT TO THIS PROVISION

All of the benefits covering medical treatment described in this Certificate are subject to the following provisions:

DEFINITIONS

(A) "THIS PLAN" means the Plan of Benefits described in this Certificate.
(B) "OTHER PLAN" means any insurance plan providing benefits or services by reason of medical or dental care or treatment provided by
  (1) group, blanket or franchise insurance coverage;
  (2) group Blue Cross, group Blue Shield, group practice and other group prepayment coverage;
  (3) any coverage under labor-management trusteed plans, union welfare plans, employer organization plans, or employee benefit organization plan;
  (4) any Workers' Compensation Law, Social Security, Medicare Parts "A" and "B" or similar legislation; and
  (5) automobile no fault coverage.
(C) "ALLOWABLE EXPENSE" means any necessary, reasonable and customary item of expense of an employee and/or dependent at least partially covered under one of the Other Plans involved. If benefit is in the form of services rather than cash payments, the reasonable cash value of each service rendered shall be considered to be both an Allowable Expense and a benefit paid.
(D) "CLAIM DETERMINATION PERIOD" means the Calendar Year, or that portion thereof during which an individual is eligible for benefits.

EFFECT ON BENEFITS

(1) This provision shall apply in determining the benefits as to a person covered under this Plan for any Claim Determination Period if for the Allowable Expenses incurred as to such a person during such Claim Determination Period, the sum of
  (a) the benefits that would be payable under this Plan in the absence of this provision, and
  (b) the benefits that would be payable under all other group health insurance plans, Workers' Compensation Law, Social Security and/or Medicare Parts "A" and "B" in the absence therein of provisions of similar purposes to this provision

would exceed such Allowable Expenses.

(2) As to any Claim Determination Period with respect to which this provision is applicable, the benefits that would be payable under this Plan in the absence of this provision for the Allowable Expenses incurred as to such person during such Claim Determination Period shall be reduced to the extent necessary so that the sum of such reduced benefits and all the benefits payable for such Allowable Expenses under all other Plans, except as provided in item (3) immediately below, shall not exceed the total of such Allowable Expenses. Benefits payable under another Plan include the benefits that would have been payable had claim been duly made therefore.

(3) If
  (a) another Plan which is involved in item (2) immediately above and which contains a provision coordinating its benefits with those of this Plan would, according to its rules, determine its benefits after the benefits of this Plan have been determined, and
  (b) the rules set forth in item (4) immediately below would require this Plan to determine its benefits before such other Plan,

then the benefits of such other Plan will be ignored for the purposes of determining the benefits under this Plan.

(4) For the purposes of item (3) immediately above, the rules establishing the order of benefit determination are:
  (a) the Benefits of a Plan which covers the person on whose expenses claim is based other than as a dependent shall be determined before the benefits of a Plan which covers such person as a dependent;
  (b) the benefits of a Plan which covers the person on whose expenses claim is based as a dependent of a male person shall be determined before the benefits of a Plan which covers such person as a dependent of a female person;
  (c) when rules (a) and (b) do not establish an order of benefit determination, the benefits of a Plan which has covered the person on whose expenses claim is based for the longer period of time shall be determined before the benefits of a Plan which has covered such person for the shorter period of time.

(5) When this provision operates to reduce the total amount of benefits otherwise payable as to a person covered under this Plan during any Claim Determination Period, each benefit that would be payable in the absence of this provision shall be reduced proportionately, and such reduced amount shall be charged against any applicable benefit limit of this Plan.

RIGHTS RESERVED BY SAFECO LIFE. For the purposes of Coordination of Benefits, the insurer
(1) may release to or obtain from any other organization or individuals any claim information, and any individual claiming benefits under This Plan shall furnish SAFECO Life with any information which it may require;
(2) has the right to pay to any other organization an amount it shall determine to be warranted, if payments which should have been made under This Plan have been made by such organizations under Other Plan; and
(3) has the right, if an overpayment is made under This Plan because of failure to report other coverage or any other reason, to recover such excess payment from any individual to whom or for, or with respect to whom such payments were made.

EVIDENCE OF INSURABILITY

(A) Under the Contributory plan of insurance SAFECO Life may require satisfactory evidence of your and/or your dependent's insurability — without cost to SAFECO Life, if
  (1) You make written application for insurance more than 31 days after your and/or your dependent's date of eligibility, or if
  (2) you reapply for insurance after the insurance has been discontinued for yourself and/or your dependent at your request, or because of your failure to make the required premium contribution to your Participating Employer, or if
  (3) you make written application for insurance for yourself or your dependents when any individual policy of life insurance or accident and sickness insurance issued previously to your and/or your dependent in accordance with a Conversion Privilege under the policy remains in force on the date of eligibility for this insurance, or if
  (4) your Participating Employer has fewer than 5 eligible employees, or if
  (5) your Participating Employer has fewer than 75% of those eligible covered, or if
  (6) required by any other of SAFECO Life's underwriting requirements.

(B) Under the Non-Contributory plan of insurance the Insurer may require satisfactory evidence of the employee's and/or dependent's insurability — without cost to the Insurer, if
  (1) See Number (3) under "Contributory Plan" above.
  (2) See Number (4) under "Contributory Plan" above.
  (3) See Number (6) under "Contributory Plan" above.

TERMINATION OF INSURANCE

EMPLOYEE

(A) Your insurance under a particular coverage of this Certificate of Insurance shall be discontinued on the earliest of the following dates:
  (1) The date your classification changes to a class of employee which is ineligible for insurance under that coverage.
  (2) the date as of which the Policy is amended making the class of employees of which you are a member ineligible for insurance under that coverage.
  (3) the date of termination of that coverage for the class of employees of which you are a member.

(B) Your insurance under all coverages of this Certificate of Insurance for which you are insured shall be discontinued on the earliest of the following dates:
  (1) The end of the month coincident with or next following the date of termination of your employment;
  (2) if insurance is provided on a Contributory Basis, the date of expiration of the period for which you last made the required premium contribution to your participating employer for insurance;
  (3) the date your Employer's Participation Agreement is discontinued as regards all insurance coverage;
  (4) the date of termination of the Policy.

DEPENDENTS

(A) The insurance of your dependent under a particular coverage of this Certificate of Insurance shall be discontinued on the earliest of the following dates:
  (1) The date your insurance classification is changed to one in which your dependents are ineligible for insurance under that coverage;
  (2) the date, as of which this Policy is amended, making your dependents of that class of employees of which you are a member ineligible for insurance under that particular coverage;
  (3) the date of termination of that coverage for your dependents of that class of employees of which you are a member.

(B) The insurance of a dependent under all coverages of this Certificate of Insurance for which your dependent is insured shall be discontinued on the earliest of the following dates:
  (1) The date of discontinuance of your insurance under all coverages for which you are insured;
  (2) the date your dependent becomes eligible as an employee for insurance under your Employer's Participation Agreement;
  (3) the date your dependent ceases to be included within the definition of the term "dependent" (see Definitions);
  (4) the date your dependent commences active duty in the armed forces of any country or state or international organization;
  (5) if your dependent's insurance is provided on a Contributory Basis, the date of expiration of the period for which you last made the required premium contribution for the insurance of your dependents.

DUAL COVERAGE

(A) No person shall be insured or eligible for insurance under this Policy simultaneously, as
  (1) an employee for more than one Participating Employer, or
  (2) as both an employee and a dependent (if coverage for dependents is included), or
  (3) as a dependent of more than one employee.

(B) If a person's insurance under a particular coverage provided by this Policy is discontinued, and if that person subsequently becomes insured again under another coverage under this Policy which provides similar benefits to those discontinued, any benefits becoming payable for medical expenses occurring during the period that benefits are extended under the prior coverage, shall be determined on the basis of the coverage providing the greater allowance, but payment shall not be made under both coverages.

DEFINITIONS

The following words and phrases used in this Certificate of Insurance will have the following meanings:

"ACCIDENT and HEALTH COVERAGE" means all coverages under the policy except Life Insurance.

"ACTIVELY AT WORK" means for the purpose of this insurance that you report for work with your Participating Employer on the date in question at your usual place of employment outside of your home and you are able to perform all of the usual and customary duties of your occupation on a regular full-time basis. If the usual place of employment is in your home, you shall be considered "Actively at Work," if at any time on the date in question, you are neither
(1) hospital confined, nor
(2) disabled to a degree that you could not then have performed your usual and customary duties on a regular, full-time basis.

"AMBULATORY SURGICAL CENTER" means any private or public establishment with an organized medical staff of physicians, with permanent facilities that are equipped and operated primarily for the purpose of performing surgical procedures, with continuous physician services and registered professional nursing services whenever a patient is in the facility, and which does not provide services or other accommodations for patients to stay overnight.

Ambulatory Surgical Center does not include an office maintained by a physician for the practice of medicine or an office maintained for the practice of dentistry.

"COMPLICATIONS OF PREGNANCY" are conditions requiring hospital confinement (when the pregnancy is not terminated), whose diagnoses are distinct from pregnancy but are adversely affected by pregnancy or are caused by pregnancy such as acute nephritis, nephrosis, cardiac decompensation, missed abortion and similar medical and surgical conditions of comparable severity. Complications of

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pregnancy also include non-elective cesarean section, ectopic pregnancy which is terminated and spontaneous termination of pregnancy, which occurs during a period of gestation in which a viable birth is not possible. Complications of pregnancy do not include false labor, occasional spotting, physician prescribed rest during the period of pregnancy, morning sickness, hyperemesis gravidarum, pre-eclampsia and similar conditions associated with the management of a difficult pregnancy not constituting a nosologically distinct complication of pregnancy.

"CONTRIBUTORY INSURANCE" means the insurance for which you must enroll and agree to make any required contribution towards the cost of the insurance.

"COVERAGE" means the insurance as described in the provisions of this Certificate of Insurance.

"DEPENDENT" shall include only the following, provided they are not eligible to be insured under this policy as employees and, if previously insured as employees, are not eligible to receive any benefits under this policy as a result of a disability existing when insurance as an employee was discontinued:

(1) Your spouse, provided such spouse is not legally separated from you, and
(2) your unmarried child from day of birth and under age 19, who is not covered under this policy as an employee or as a dependent of another employee.

Any unmarried child age 19 but less than age 23 shall be considered as a dependent only if attending an institution of higher learning as a full-time student, is not employed on a full-time basis, and has the same home address as the employee.

The term "child" includes any legally adopted child, any stepchild, any foster child and any child supported solely by the employee, and provided such child is permanently residing in the household of which the employee is the head.

The definition of "Dependent" shall include as a dependent an unmarried child who is otherwise eligible for coverage and who is dependent upon the insured for support and maintenance and is and continues to be incapable of self-support due to developmental disability or physical handicap, provided the insured submits satisfactory proof of such dependent's incapacity to SAFECO not later than 31 days after the attainment of the age limit of such dependent child and subsequently as may be required by SAFECO, but not more frequently than annually after the two year period following the child's attainment of the limiting age.

Excluding in any case:

(1) any person residing outside the United States and Canada,
(2) any person in the military or similar forces of any country or subdivision.

"FULL-TIME EMPLOYEE" means only an employee who customarily works a regularly scheduled work week with a Participating Employer of at least 30 hours per week and shall include a proprietor or partner, who is actively engaged in and regularly devotes at least 30 hours per week to the conduct of the business. The employee is also referred to as you in this certificate.

"HOSPITAL" means

(1) an institution operated pursuant to law for the care and treatment of sick and injured persons, under the supervision of one or more licensed physicians, which
    (a) provides 24 hours nursing care on a resident in-patient basis,
    (b) has organized facilities both for diagnosis and for surgery, or
    (c) a properly licensed alcoholism treatment facility, for mental and nervous conditions only, surgical facilities are not necessary.
(2) A "Convalescent Hospital" which is operated pursuant to law and primarily engaged in providing room and board, together with 24-hour-a-day nursing service by one or more professional nurses and such other nursing personnel as are needed to provide adequate medical care, for persons convalescing from sickness or injury, and provides such services under the supervision of a proprietor or employee who is a licensed physician or a registered graduate nurse (R.N.) and who is devoting full time to such supervision, and maintains adequate medical records, and has available the services of a licensed physician, under an established agreement, if not supervised by a licensed physician.

The term "hospital" is not meant to include

(1) a hotel, rest home, nursing home, convalescent home (except as outlined in (2) above), place for custodial care, home for the aged, or
(2) a place used primarily for the confinement or treatment of drug addicts,
(3) an institution operated by a state, county or city for the care of the mentally ill or any governmental agency of the United States or Canada.

"HOSPITAL CONFINEMENT" means that you shall be considered to be confined in a hospital* for the purposes of this Certificate of Insurance:

(1) if your confinement continues for 18 consecutive hours or longer, or
(2) if a board and room charge is made in connection with your confinement, or
(3) if the confinement results from a non-occupational injury requiring emergency care and commences prior to midnight of the day following the date of the injury, or
(4) if the confinement is required because of a surgical procedure.

*Note: Confinement in a convalescent hospital or a place principally for nursing care shall be "hospital confinement" under this Certificate of Insurance only when such confinement:

(a) is preceded by confinement of at least 5 days in a hospital, as defined under "HOSPITAL" (1) above,
(b) is prescribed by a licensed physician,
(c) commences within 7 days after discharge from the previous hospital confinement,
(d) requires personal visits by a licensed physician at least once every 7 days,
(e) does not exceed during the lifetime of the person, 365 days.

"INJURY" means only a bodily injury sustained accidentally by external means.

"INSURER" means the SAFECO Life Insurance Company — Home Office, Seattle, Washington.

"MEDICALLY NECESSARY" means

(1) There is a disease or injury present which requires treatment, and
(2) the procedure, service or supply used to treat the disease or injury is required and is generally professionally accepted as the usual, customary and effective means of treating the condition.

Diagnostic X-rays and laboratory procedures are considered necessary when they are performed as a result of definite symptoms of a disease or injury or if they reveal the need for treatment.

"NON-CONTRIBUTORY INSURANCE" means insurance for which you do not contribute towards the cost of the insurance.

"NON-OCCUPATIONAL" means with respect to an injury or disease that in connection with which you are not entitled to benefits under any Workers' Compensation law or similar legislation.

"PARTICIPATING EMPLOYER" means for the purpose of this insurance your Employer who is covering you through this Plan.

"PHYSICIAN" means only a person who is duly licensed and acting within the scope of such license.

"POLICYHOLDER" means SAFECO HEALTHCARE TRUST, Seattle, Washington.

"REASONABLE AND CUSTOMARY" means a charge shall be considered reasonable and customary to the extent that it does not exceed the general level of charges being made by others of similar standing in the locality where incurred.

"SURGICAL PROCEDURE" means only the following:

(1) A cutting operation,
(2) suturing of a wound,
(3) treatment of a fracture,
(4) reduction of a dislocation,
(5) radiotherapy, if used in lieu of a cutting operation,
(6) electrocauterization,
(7) diagnostic and therapeutic endoscopic procedures,
(8) injection treatment of hemorrhoids and varicose veins.

"TOTALLY DISABLED" means, as used in the Accident and Health coverages (other than Disability Income Coverage)

(1) for Employees — disability to the extent that you are not able to perform the usual and customary duties of your occupation, and
(2) for Dependent coverage (if provided under the Employer's Agreement) — disability to the extent that your dependent can perform none of the usual and customary duties or activities of a person in good health and of the same age and sex.

"WAITING PERIOD" means the length of continuous active service with your Participating Employer which you must complete to become eligible for the insurance.

"WRITTEN NOTICE" means notice in writing in a form supplied by or satisfactory to SAFECO Life for that purpose.

"YOU" refers to the certificate holder ("employee").

9 · Life Insurance

PERFORMANCE OBJECTIVES

After studying this chapter, you should be able to:

- Explain why you do or do not need life insurance.
- Determine how much coverage you need now, taking into consideration probable expenses and probable sources of income (including Social Security and returns from investments).
- Explain how one's needs for life insurance change over time—depending on the number and age of one's dependents, one's age, assets, and lifestyle—and therefore necessitate periodic reevaluation.
- Describe the five basic variables in life insurance policies: protection, savings, face amount, policy period, and premium.
- Explain the difference between term insurance and cash value insurance and describe the types of policies available in each of these two categories.
- Describe the clauses that make up the life insurance contract.
- Shop for life insurance, taking advantage of cost differences from one company to another.

OUTLINE OF THE MAIN IDEAS

I. Life insurance is protection for your dependents against the loss of your income after you die. You need it only if you have dependents who need your income. To determine the amount you need, use the eight-step method considering your dependents' needs now, not 10 or 20 years from now.
   A. Estimate the amounts needed for funeral, administrative, and estate tax expenses. Add up your liabilities (except home mortgage) and estimate your annual living expenses.
   B. Estimate the income your family would have from your spouse's employment, Social Security benefits, and other sources. Take your family's ages into consideration.
   C. Remember that insurance needs change over time but in general decrease as your assets increase. Insurance is most important while your needs exceed your assets. Reevaluate every five years or upon occurrence of a major event, such as the birth of a child.
   D. Self-insurance is possible when assets and Social Security benefits exceed your decreasing needs.

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E. Keep in mind that you could invest a policy's cash value rather than hold it at face value.

F. You can reduce your life insurance needs in three basic ways.

1. Reducing your family's standard of living
2. Increasing investments, thereby increasing assets
3. Increasing the yield on your investments

II. There are five basic variables in life insurance policies.

A. *Protection* (amount of the insurance) may increase, decrease, or remain the same depending on the type of policy.

B. *Savings* is provided by cash value policies, but the protection element decreases as the savings element increases.

C. *Face amount* is the amount payable at the death of the insured.

D. The *policy period* may be for life or a specified term of years.

E. The *premium* is the amount you pay for protection. It depends on the other four variables and on your age and health.

III. There are two basic kinds of life insurance.

A. *Term insurance* is pure insurance for a set period of time. It has no savings element or cash value and requires the smallest premiums.

1. *Renewable term insurance* can be renewed annually or at the end of term periods.
2. *Level term insurance* provides the longest period of protection.
3. *Decreasing term insurance* may keep the premium level but decrease the benefits over time.
4. *Mortgage term insurance* decreases benefits more quickly toward the end of the term.

B. *Cash value insurance* combines decreasing term insurance with a savings plan. There are three kinds of cash value insurance.

1. *Ordinary, whole,* or *straight life* are different names for the same policy. Its premiums are level and continue for life or until you cash it in, and it is the least expensive of the cash value policies.
2. *Limited payment life* is like whole life except that it becomes paid up in a fixed amount of time. It enables the policyholder to meet insurance costs during income-producing years.
3. *Endowment* policies build up cash value such that at maturity there is no term insurance protection left. It is designed for people who want protection while building up an investment.

IV. Choosing the right policy for you is a personal matter. You should understand the terms of the insurance contract so that you know what you are buying.

A. The *beneficiary clause* states who will receive the benefits. You may name a contingent beneficiary who will receive the benefits if the primary beneficiary dies before the distribution.

B. *Settlement options* allow you to decide how the benefits will be distributed—whether as a lump sum, paid over time, etc.

1. *Installment payments* provide monthly income either over a fixed period or at a fixed amount.
2. *The interest option* allows the payee to receive the interest only on the cash value which, upon death, reverts to his or her estate.
3. *The annuity option* provides monthly payments for life. There are four standard annuity options.
   a. *The straight life annuity* offers monthly payments for life, but when you die the company retains the remaining funds.
   b. *The refund annuity* gives you an income and pays the remainder to your heirs when you die.
   c. *Certain and continuous annuity* continues payments to your heirs for the remainder of a set period.
   d. *Joint and survivorship annuity* makes monthly payments for life for two persons, who need not be related. If one dies, payments continue to the other at a specified rate.
4. *The lump-sum option* gives the beneficiary the full face amount of the policy, which he or she can then invest or use in other ways.

C. The *loan clause* lets you borrow on your policy.

D. The *premium payment clause* sets the rate and schedule of your payments.

E. The *dividend clause* provides for a refund of premiums when paid to policyholders. There are six dividend options.
   1. You can spend your dividend or bank it yourself.
   2. You can apply it to your premium payments.
   3. You can leave it with the insurance company to draw interest.
   4. You can use it to buy paid-up cash value additions.
   5. You can use it to buy paid-up term insurance additions.
   6. You can use some to buy term insurance and leave the rest with the company to earn interest.

F. The *nonforfeiture clause* is contained only in cash value policies. It declares your options if you default on your policy.
   1. You can withdraw the cash value as a lump sum.
   2. You can trade the cash value for a much smaller paid-up cash value policy.
   3. You can trade the cash value for a paid-up term policy for a shorter period than the former policy but for the same face value.

G. The *reinstatement clause* allows policyholders whose policies have lapsed or been discontinued to put them in force again.

H. The *change of policy clause* allows you to change to coverages with a higher annual premium by paying the difference in premiums.

I. The *suicide provision clause* provides that no benefits will be paid if the policyholder commits suicide within 2 years of the policy's purchase date.

V. You should always shop for rates before buying life insurance.
   A. You may be able to get a discount on quantity or through group insurance.
   B. The cost of a policy is based on its term, its cash value, and its maintenance costs.
      1. The life insurance industry traditionally used the *net cost* or *average payment* method in which the annual increase in cash value plus any dividends are deducted from the annual premiums. However, this method ignores the fact that money not spent in a premium today can earn interest and that a dividend received in the first year is more valuable than one received later.
      2. To overcome the deficiencies of the net cost method, the *interest-adjusted method* considers the time various payments are made.

SELF-TESTING EXERCISES

True-False

____ 1. It is easier to determine whether you need life insurance than to determine the amount you need.

____ 2. The least expensive type of cash value insurance is whole life.

____ 3. It is possible to buy life insurance and have it all paid up after a certain period.

____ 4. The installment option allows a beneficiary to elect to receive payments of interest only, the principal reverting to his estate after death.

____ 5. In a certain and continuous annuity settlement option, if the payee dies within a specified time period, the payments will be made to the payee's heirs for the remainder of the period.

____ 6. Dividends paid by mutual life insurance companies are distributions of the profits of these companies.

____ 7. Nonforfeiture clauses appear only in cash value policies.

____ 8. The interest-adjusted method of determining the cost of life insurance is the traditional method used by life insurance companies.

____ 9. You may borrow against the cash value of your policy.

____ 10. To avoid dissipation of benefits, it is necessary to use settlement options other than the lump-sum option.

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Completion

1. The primary purpose of life insurance is ____________________.
2. The amount payable by a life insurance policy upon death is the ______________________________ ____________________.
3. The amount you pay for protection in a life insurance policy is called the ____________________.
4. The ____________________ ____________________ may be for life or a specified period.
5. Life insurance policies that combine ____________________ with protection are called cash value policies.
6. A policy that is pure protection is called a ____________________ policy.
7. A term policy with a level premium but decreasing benefits is called ____________________ term insurance.
8. ____________________ policies are designed for people who want protection while building up their investments.
9. To compare term insurance with ____________________ ____________________ insurance, we must assume that the difference in premiums is invested personally.
10. The ____________________ ____________________ settlement option provides that, at the death of the annuitant, the remainder goes to the annuitant's heirs.

Multiple Choice

1. The *interest-adjusted method* is a way of comparing

   a. premiums
   b. loan values
   c. face amounts
   d. dividends

2. Which of the following is NOT a common way to pay life insurance premiums?

   a. Monthly
   b. Bimonthly
   c. Semiannually
   d. Annually
   e. Quarterly

3. An insured with $10,000 of ordinary life insurance dies with $1,000 of accumulated dividends in the policy and a $2,000 policy loan outstanding. What will the insurance company pay to the beneficiaries?

   a. $11,000
   b. $10,000
   c. $9,000
   d. $8,000

4. If an insurance company collected a total of $7,240,000 in premiums and paid out, including their expenses, $6,940,000 in claims, how much could each of 100,000 policyholders receive in dividends, assuming all 100,000 carried $50,000 worth of insurance?

   a. $3
   b. $15
   c. $30
   d. $150

5. If 423 out of every 100,000 people age 45 die, how much per $1,000 of coverage must the insurance industry charge each of these 100,000 people, not including operating costs, if each of the 423 who died carried $20,000 worth of insurance?

   a. $84.60
   b. $40.23
   c. $4.23
   d. $2.12

6. Which of the following is a way in which policies may differ?
   a. The saving vs. protection portion
   b. The face amount
   c. The premium
   d. The policy period
   e. (All of the above)

7. The *lump sum* option is found in which of the following policy clauses?
   a. The reinstatement clause
   b. The dividend clause
   c. The premium payment clause
   d. The nonforfeiture option clause
   e. The settlement option clause

8. Which of the following is not a type of cash value life insurance?
   a. Straight
   b. Limited payment
   c. Ordinary
   d. Uniform decreasing
   e. Endowment

9. Term insurance differs from cash value insurance because
   a. term provides pure protection only, no savings element
   b. over the life of the insured, term insurance always costs less than cash value
   c. over the life of the insured, cash value insurance always costs less than term
   d. term insurance does not have a settlement option clause

10. You can reduce your needs for life insurance by
    a. having your dependents work for a living in the event of your death
    b. earning a higher yield on your investments
    c. devoting more money to investments
    d. reducing your family's standard of living after your death
    e. (All of the above)

Cases and Problems

1. Mary is 40 years old with a life expectancy of 37 years. Her premium for a $20,000 policy is $340. The policy has a cash value of $2,500 and an annual dividend of $50.
   a. How much would the policy pay her beneficiary should she die now?
   b. What is the annual cost of her policy?
   c. Using compound interest Table B, determine when her total investment would equal what her policy would pay her ($20,000 − $2,500 cash value now = $17,500) if she canceled her policy and reinvested the annual net premium at a yield of 5 percent.

2. An insurance agent friend of Jim's urges him to buy a life insurance policy now even though he has no dependents on the grounds that if he waits, his added age will increase the payment. Advise Jim.

3. Ted pays $320 a year for a $50,000 policy that is estimated to pay dividends of $75 a year and to increase in cash value by $150 at the end of the first year. The company pays 4 percent interest on dividends deposited and charges 6 percent on cash value loans on the policy. What would each of the following alternatives be worth to him? (Ignore the effect of income taxes.)
   a. Pay the annual premiums and leave the dividend with the company.
   b. Deduct the dividend from the premium and invest it.
   c. Deduct the dividend from the premium and borrow the cash value and invest their sum himself.

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4. Using the blank form for the eight-step procedure, help Chad and Sally determine how much life insurance they should buy on Chad. They have gathered the following information:
    - Their gross estate is $17,000.
    - Chad earns $1,200 a month.
    - They plan to send their only child, Jeremy, to a private college for four years.
    - They project the family's average annual living expenses to be $12,000 if Chad were to die now.
    - They have $2,800 in debts.
    - Sally plans to work part-time until Jeremy starts college (in eight years), earning $5,000 a year after taxes. After Jeremy leaves home to go to college, she plans to earn an average of $11,000 a year after taxes until she retires at age 65. (She is 40 years old now.)
    - They have investment assets of $12,500.
    - They feel comfortable with riskier types of investments such as real estate and stocks.

PERSONAL MONEY MANAGEMENT ACTIVITIES

1. Use the eight-step procedure to determine how much life insurance you need for yourself. If you have no dependents you can skip this activity.
2. If you did the above activity, call several different life insurance companies for rate quotes on both renewable annual term insurance and straight life insurance. Find out whether the lower quotes come from the largest and widely advertised companies.

ADDITIONAL ACTIVITIES

1. Review the sample cash value table (page 80) for a policy purchased when the insured was 35. Notice the columns for "tabular cash or loan value," "paid-up insurance," and the "nonforfeiture factors." Also notice how the cash value increases. Compare this with compound interest Table A in the text.
2. Review the sample life insurance policy provided on pages 81–85. Notice the wording of the eight important clauses.

TABLE OF CASH, LOAN AND NON-FORFEITURE VALUES

PER $1.000 OF FACE AMOUNT

End of Policy Year	TABULAR CASH OR LOAN VALUE	PARTICIPATING PAID-UP INSURANCE	NON-PARTICIPATING EXTENDED INSURANCE (The period of years and days shown below is the same for policies of any amount.)		End of Policy Year
			YEARS	DAYS	
1	•••	•••	••	•••	1
2	$ 20	$ 50	5	202	2
3	40	97	9	98	3
4	61	145	12	10	4
5	82	190	14	16	5
6	100	226	15	87	6
7	117	258	16	21	7
8	135	290	16	276	8
9	153	321	17	102	9
10	171	351	17	242	10
11	189	379	17	341	11
12	208	408	18	61	12
13	227	435	18	112	13
14	246	461	18	136	14
15	265	486	18	137	15
16	284	510	18	119	16
17	303	532	18	85	17
18	322	554	18	38	18
19	342	577	17	364	19
20	361	597	17	299	20
AGE 60	419	654	17	82	AGE 60
AGE 65	514	735	15	328	AGE 65

NON-FORFEITURE FACTORS (applicable during premium paying period)
First 5 Policy Years $22.716
Thereafter $18.337

Tabular cash values equal full net premium reserve from 5TH policy anniversary

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INSURANCE BENEFIT

The death benefit proceeds under this policy will be paid to the beneficiary immediately upon receipt of due proof of the Insured's death. Such proceeds shall include the face amount of the policy together with any other benefit payable under the terms of the policy because of such death.

GENERAL PROVISIONS

1. The Contract

This policy and the application for it, a copy of which is attached to and made a part of the policy, constitute the entire contract. All statements made in the application will be deemed representations and not warranties. No statement will be used to invalidate the policy nor to defend against a claim under it unless contained in the application.

The contract is made in consideration of such application and the payment of premiums in accordance with the provisions of the policy.

Only the President, Executive Vice-President, Vice-President, Treasurer or Secretary of the Company at its Home Office can make or modify this contract or waive any of the Company's rights or requirements.

All payments by the Company under this policy are payable at the Company's Home Office in New York City.

2. Definitions

Every reference in this policy to:

"dividend credits" means outstanding dividends and dividend deposits and the reserve on outstanding dividend additions.

"indebtedness" means indebtedness to the Company against the policy;

"tabular cash value" means the cash value determined in accordance with the Table of Cash, Loan and Non-Forfeiture Values shown in the policy;

"age" means age nearest birthday. Any reference to a specified age in the Table of Cash, Loan and Non-Forfeiture Values or the Premium Schedule in the policy shall mean the policy anniversary on which the Insured's age, nearest birthday, is the specified age.

3. Effective Date of Policy

This policy is deemed to have taken effect as of the policy date shown on its first page. Policy years, months and anniversaries will be determined from the policy date.

4. Payment of Premiums

Premiums are payable during the Insured's lifetime in accordance with the Premium Schedule, in exchange for a receipt signed by the President or Secretary of the Company and duly countersigned. Any date in the Premium Schedule which was based on the assumption that the Insured would be a specified age on such date shall be corrected, if necessary, to agree with the Insured's true age, nearest birthday.

After payment of the first premium, failure to pay a premium on or before its due date, to the Company at its Home Office or to a duly authorized Office Manager of the Company, will constitute default in payment of premium.

Premiums may be made payable at annual, semi-annual, quarterly or monthly intervals at the Company's applicable premium rate for the mode of payment requested, subject to the Company's approval. Payment to and acceptance by the Company of a premium on a new mode of payment shall constitute a change in mode for subsequent premiums.

Grace Period. A grace period of thirty-one days will be allowed for payment of a premium in default, during which time this policy will continue in force. If a premium remains unpaid after expiration of the grace period, insurance will be in force only to the extent provided under the policy's Non-Forfeiture provisions.

5. Beneficiary

Unless otherwise provided in this policy or in a beneficiary designation in effect under the policy, the following provisions shall apply:

Beneficiary Classifications. The beneficiary for any death benefit proceeds under this policy will be classified as a first beneficiary, second beneficiary or third beneficiary. Such classification shall determine the interest of that beneficiary with respect to such death benefit proceeds. Surviving beneficiaries in the same beneficiary classification shall share equally in death benefit proceeds payable to the beneficiaries in that classification.

Payment to Beneficiaries. Death benefit proceeds payable to the beneficiaries under this policy will be paid:

to any first beneficiaries for such proceeds surviving at the time of the Insured's death, or

if no first beneficiary for such proceeds survives the Insured, to any second beneficiaries for such proceeds surviving at the time of the Insured's death, or

if no first or second beneficiary for such proceeds survives the Insured, to any third beneficiaries for such proceeds surviving at the time of the Insured's death.

Death of Beneficiary. If the last surviving beneficiary for any death benefit proceeds payable under this policy predeceases the Insured, the beneficial interest in such proceeds shall vest in the Owner. If any beneficiary dies simultaneously with the Insured or within fifteen days after the Insured but before due proof of the Insured's death has been received by the Company, the proceeds of the policy will be paid to the same payee or payees and in the same manner as though such beneficiary predeceased the Insured.

GENERAL PROVISIONS (continued)

6. Change of Beneficiary

While the Insured is living, the beneficiary designation can be changed from time to time by written notice in form satisfactory to the Company. No such change will take effect unless recorded in the records of the Company at its Home Office. Upon being so recorded, the change will be effective as of the date the notice was signed, whether or not the Insured is living when the change is recorded, subject to any payment made or other action taken by the Company before such recording.

7. Ownership of Policy

All benefits, rights and privileges available under this policy during the Insured's lifetime are vested in the Owner and may be exercised without the consent of any beneficiary or Owner's Designee.

8. Arrangements for Transfer of Ownership

The Owner, by written request satisfactory to the Company accompanied by the policy for appropriate indorsement, can arrange for a transfer of his entire ownership

(a) to a new Owner, effective immediately, or

(b) to an Owner's Designee who, upon the death of the designating Owner before his rights of ownership terminate, will become the new Owner. Any designation of Owner's Designee can be terminated or changed from time to time in a similar manner.

Such new Owner shall succeed to the benefits, rights and privileges of the previous Owner, subject to the terms and conditions of the policy and the interest of any existing assignee. The new Owner is not an "assignee" and the transfer is not an "assignment" within the meaning of those words as used in this policy.

No arrangement for transfer of ownership will take effect unless it is indorsed on the policy, but upon being so indorsed will take effect as of the date such request was signed, subject to any payment made or other action taken by the Company before such indorsement.

Any interest as Owner's Designee shall automatically terminate if a transfer is made under (a) above or if such Owner's Designee does not survive the designating Owner. Transfer of ownership will not act to change the beneficiary nor to transfer the interest of the beneficiary.

9. Assignment

A duplicate copy of any assignment of this policy, or of any interest in it, must be filed with the Company. Any assignment shall be subject to any payment made or other action taken by the Company before the assignment is received and recorded at the Company's Home Office. The Company assumes no responsibility for the validity of any assignment.

The interest of any beneficiary or Owner's Designee under this policy shall be subordinate to the interest of any assignee and may be assigned by the Owner while the Insured is living.

An assignee cannot change the beneficiary nor exercise the rights set forth in the Arrangements for Transfer of Ownership provisions of this policy.

10. Dividends

This is a participating contract and its share of divisible surplus will be determined annually by the Company. On each anniversary of this policy, any share of divisible surplus apportioned to it will be payable as a dividend if this policy is then in force and all premiums due have been paid to such anniversary. The dividend, when payable, will be applied under one of the following options, as elected:

(a) ***Cash*** — Paid in cash.

(b) ***Premium*** — Applied toward payment of a premium due if the balance of such premium is paid.

(c) ***Dividend Addition*** — Applied at net single premium rates to provide a participating paid-up addition to the sum insured.

(d) ***Dividend Deposit*** — Left with the Company at interest, subject to withdrawal. On each succeeding policy anniversary, interest will be credited on outstanding dividend deposits at such rate (not less than 3% per annum) as the Company may declare.

If no option is elected, option (c) will apply.

It is not expected that a dividend will be payable on this policy before its second anniversary.

Any outstanding dividend addition can be surrendered at any time for an amount equal to the reserve on such addition as of the latest policy anniversary. Dividend additions and dividend deposits outstanding at the maturity of the policy by death will be payable as part of the policy proceeds.

Post-Mortem Dividend. If this policy matures by the death of the Insured, any post-mortem dividend apportioned to it will be paid as part of death benefit proceeds.

Fully Paid-up Policy Privilege. This policy will be made fully paid-up by application of dividend credits as of any premium due date on which its tabular cash value plus such dividend credits equals or exceeds the net single premium (calculated on the same basis as the premium for this policy) for such fully paid-up participating policy at the Insured's attained age, upon written request within thirty-one days of such premium due date.

Endowment Privilege. This policy will be matured as an endowment by application of dividend credits upon written request when its tabular cash value plus such dividend credits equals or exceeds the face amount of the policy.

11. Change Privilege

The following changes can be made in this policy:

(a) ***Changes to Higher Premium Plans.*** If no premium is in default, the plan of insurance will be changed to an endowment or limited payment life insurance plan for the same level face amount, but with a higher premium rate and a premium paying period which extends for at least five full years beyond the effective date of the change, without evidence of insurability and without any change in the classification of the risk, upon receipt by the Company at its Home Office of the Owner's written request for such change accompanied by the policy and a payment of

(i) the difference in previously due premiums for the basic life or endowment insurance benefits under the two plans, where the change is to take effect on or before the second anniversary of this policy, or

(ii) 103% of the difference in the then current cash values for the two plans, where the change is to take effect after the second anniversary of this policy.

The new plan must be one which was available on the policy date of this policy. Subject to the same condition and such additional payment, if any, as may be required, provision for an Accidental Death Benefit may be included in the new plan if a corresponding provision is included in this policy. However, the inclusion in the new plan of a provision for any benefit other than such Accidental Death Benefit and the basic life or endowment insurance benefit on the life of the Insured shall be subject to the Company's approval and requirements.

(b) ***Other Changes.*** Any other change in this policy, including changes to a lesser amount of insurance or to a plan of insurance with a lower premium rate, shall be subject to the Company's approval and requirements.

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GENERAL PROVISIONS (continued)

12. Reinstatement

Within five years after default in payment of premium, this policy may be reinstated upon receipt by the Company of (a) evidence of insurability satisfactory to the Company, (b) payment of all overdue premiums with interest at 5% per annum from their respective due dates and (c) payment of any indebtedness outstanding at the end of the grace period, with compound interest at 5% per annum, plus any outstanding indebtedness incurred thereafter. However, if the Company receives the payments required under (b) and (c) within thirty-one days after expiration of the grace period for payment of the premium in default, the Company will not inquire into, nor require submission of, evidence of insurability but, in such case, reinstatement shall not take effect unless the Insured was living when such payments were received.

Upon the Owner's written request, all or part of the payment required to reinstate the policy can be charged against it as a loan under the Policy Loans provisions if the resulting indebtedness does not exceed the policy's loan value on the date of reinstatement.

13. Age and Sex

If the age or sex of the Insured has been misstated, any amount payable by the Company under this policy shall be such as the premium paid would have purchased on the basis of the correct age and sex.

14. Suicide

Suicide of the Insured, while sane or insane, within one year from the date of issue, is a risk not assumed under this policy. In such event premiums paid for the policy, less any indebtedness, will be refunded.

15. Indebtedness

Any indebtedness will be deducted in determining the amount of proceeds payable in any settlement under this policy.

16. Settlement on Maturity or Surrender

This policy will be settled in accordance with its terms upon receipt of due proof of the Insured's death or upon its maturity as an endowment or its surrender for cash value. Surrender of the policy will be required when such settlement is made.

Death Benefit Premium Adjustment. Death benefit proceeds under this policy will be subject to adjustment, as follows:

(a) Such proceeds will be increased, if a premium was paid for the premium interval current at the time of the Insured's death, by such pro-rata part of that premium as is applicable to the period, if any, between the end of the policy month in which death occurs and the end of such premium interval;

(b) Such proceeds will be decreased, if the Insured dies during a grace period, by such pro-rata part of any overdue premium as would be applicable to the period ending with the last day of the policy month in which death occurs.

Interest on Single Sum Death Benefit. Interest at the rate (not less than 3% per annum) declared by the Company will be included in death benefit proceeds which are paid in a single sum. Such interest will be for the period from the date of the Insured's death to the date the proceeds are paid, but not for a period of more than two years.

17. Protection Against Creditors

To the extent allowed by law and subject to the terms and conditions of this policy, all benefits and money available or paid to any person and relating in any manner to this policy will be exempt and free from such person's debts, contracts and engagements, and from judicial process to levy upon or attach the same.

18. Incontestability

This policy shall be incontestable, except for non-payment of premium, after it has been in force during the lifetime of the Insured for one year from its date of issue.

LOAN PROVISIONS

1. Policy Loans

The Company will advance, on the sole security of the values provided under this policy, an amount up to its loan value at any time after the policy has a loan value, unless it is being continued as Extended Insurance. The loan value on a premium due date, or during the grace period, will be equal to the policy's cash value. The loan value at any other time will be the amount which, with interest, will equal the cash value on the next interest due date or next premium due date if earlier.

Such advance shall bear interest, at the rate of 5% per annum, due on each policy anniversary or on any other date approved by the Company. Interest not paid when due will be added to the principal and will bear interest at the same rate. Any such advance, together with interest as it accrues from day to day, will constitute an indebtedness.

The advance will be made upon receipt of such evidence of it as the Company may require. Any existing indebtedness will be deducted from such advance. The Company may defer making an advance, other than to pay any premium due the Company, for a period not exceeding six months from the date application for such advance is received by the Company.

Any indebtedness may be repaid, in whole or in part, at any time before this policy matures by the Insured's death or as an endowment, except that, if the policy is being continued under its Non-Forfeiture provisions, any indebtedness which was deducted in determining the non-forfeiture benefit may not be repaid unless the policy is reinstated.

Whenever the indebtedness exceeds the cash value, the policy shall be void thirty-one days after the Company has mailed notice to the last known address of the Owner and of the assignee of record, if any.

LOAN PROVISIONS *(continued)*

Term Insurance for Policy Loan. Before the policy anniversary on which the Insured's age is 65, the Owner may obtain term insurance, in accordance with the Company's rules with respect to such insurance, on the life of the Insured in the amount of any loan under this policy, subject to receipt of such evidence of insurability as the Company may require and payment of the appropriate premium according to the Company's premium rates for such insurance. If such insurance becomes payable, it will be applied against indebtedness.

2. Automatic Premium Loan Option

The automatic premium loan option will be in effect if requested in the application for this policy or in a written request received by the Company from the Owner before expiration of the grace period for payment of a premium in default. If this option is in effect, any premium in default will be automatically paid immediately before expiration of the grace period by making an advance, as under the Policy Loans provisions and subject to the terms and conditions of such provisions, sufficient to pay such premium unless (a) the resulting indebtedness would exceed the loan value of the policy, or (b) the two consecutive premiums immediately preceding such overdue premium were payable at other than monthly intervals and were paid by automatic premium loans, or (c) the six consecutive premiums immediately preceding such overdue premium were payable at monthly intervals and were paid by automatic premium loans.

Upon receipt by the Company of the Owner's written request for termination of this option, it will cease to be in effect with respect to any premium then due but unpaid and to subsequent premiums, but may be made effective again by the Owner's subsequent written request.

CASH AND NON-FORFEITURE BENEFITS

1. Cash Value

This policy can be surrendered for its cash value at any time after it first has such a value.

If no premium is in default, the cash value of this policy will be its tabular cash value plus any dividend credits. If the policy has become fully paid-up, its cash value will be the reserve on the paid-up insurance plus any dividend credits.

Within three months after the due date of a premium in default, the cash value of this policy will be the same as on that due date, reduced by any subsequent withdrawal of dividend credits.

After such three months, the cash value will be the reserve on any insurance provided under the policy's Non-Forfeiture provisions plus any dividend credits, however, if the policy is surrendered within thirty-one days after a policy anniversary, the reserve on such insurance will be taken as not less than on that anniversary.

The Company may defer payment of any cash value for a period not exceeding six months from the date of surrender. If payment is deferred for thirty days or more, such cash value, less any indebtedness, will bear interest at the rate of 3% per annum for the period of deferment.

2. Non-Forfeiture

The following non-forfeiture benefits will apply if this policy has a cash value and a premium in default remains unpaid.

(a) ***Extended Insurance.*** Upon expiration of the grace period, this policy will be automatically continued as non-participating term insurance commencing as from the due date of the premium in default. The amount of such insurance will be equal to the face amount of the policy plus any outstanding dividends, dividend deposits and dividend additions and less any indebtedness. The term period will be such as the cash value, less any indebtedness, would provide if applied as a net single premium at the Insured's attained age on the due date of the premium in default.

The election of Paid-up Insurance or the surrender of the policy for cash value within three months after the due date of such premium will revoke any Extended Insurance from such due date.

(b) ***Paid-up Insurance.*** Within three months after the due date of the premium in default, this policy will, upon written request, be continued as participating paid-up life insurance for such amount as the policy's cash value, less any indebtedness, would provide if applied as a net single premium at the Insured's attained age on such due date.

(c) ***Cash Value.*** The policy can be surrendered in accordance with the Cash Value provisions.

3. Basis of Computation

Tabular cash values and the corresponding non-forfeiture values are based on the assumptions that (a) this policy has been in force and all premiums due have been paid to the end of the number of policy years stated, (b) there are no dividend credits and (c) there is no indebtedness. Any value not shown in the table will be furnished by the Company upon request.

Tabular cash values are computed by the Standard Non-Forfeiture Value Method, using the applicable non-forfeiture factors set forth in the Table of Cash, Loan and Non-Forfeiture Values. Such values at any time during a policy year will be determined by the Company with due allowance for the time elapsed in that year and the date to which premiums that have become due have been paid. Tabular cash values are equal to the full net premium reserve from the policy anniversary specified in the table.

A detailed statement of the method of computation of cash and non-forfeiture values has been filed with the insurance supervisory official of the jurisdiction in which this policy is delivered. All values for this policy are equal to or greater than those required by statute in such jurisdiction.

Reserves, net single premiums, and cash and non-forfeiture values referred to in the Cash and Non-Forfeiture Benefits provisions, and reserves on, and net single premiums for, outstanding dividend additions wherever referred to in this policy, are based on the Commissioners 1958 Standard Ordinary Table of Mortality where the Insured is a male, or the Commissioners 1958 Standard Ordinary Female Table of Mortality where the Insured is a female, with continuous functions and interest at the rate of 3% compounded annually.

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OPTIONAL METHODS OF SETTLEMENT

The death benefit, matured endowment or cash value proceeds of this policy, in whole or in part, can be settled under one of the following options instead of being paid in a single sum if every payee under the option is a natural person taking in his own right, subject to the terms and conditions of these Optional Methods of Settlement provisions.

Option 1. Withdrawable Deposit. Left on deposit, subject to withdrawal in sums of not less than $100. Interest will be credited annually at the rate (not less than 3%) declared by the Company each year under this option on the amount remaining with the Company on the interest credit date.

Option 2. Income for Specified Period. Equal monthly payments for the number of years elected, in accordance with the Option 2 Table.

Option 3. Annuity for Life:

With Certain Period. Equal monthly payments for five, ten, fifteen or twenty years (the certain period), as elected, and thereafter for the remaining lifetime of the payee; or

With Instalment Refund. Equal monthly payments until the sum of such payments equals the proceeds settled under this option (at which time the instalment refund period ends) and thereafter for the remaining lifetime of the payee.

The amount of each monthly payment will be in accordance with the Option 3 Table.

Option 4. Interest Payments. Left with the Company with interest payable at the rate declared by the Company each year under this option, until the death of the payee. The Company guarantees that such interest, per $1,000 remaining with the Company under this option on the interest due date, will not be less than the following, according to the frequency of payment elected:

Annual	Semi-annual	Quarterly	Monthly
$30.00	$14.89	$7.42	$2.47

Option 5. Income of Specified Amount. Equal monthly, quarterly, semi-annual or annual payments of specified amount, as elected, if the total amount payable each year is at least five percent of the proceeds settled under this option. Payments will be made until such proceeds, together with accrued interest at the rate (not less than 3%) declared by the Company each year under this option, have been paid.

Option 6. Annuity for Life — Two Persons. Equal monthly payments, in accordance with the Option 6 Table, for the joint lifetime of two payees and continuing for the remaining lifetime of the survivor. Such payments will be payable for ten years certain if both payees die sooner.

If one of the payees named in an election of Option 6 dies before becoming entitled to the first payment, settlement will be made instead under Option 3 (Ten Years Certain) with the surviving payee.

Deferred Settlement Option. Left with the Company at interest, as under Option 4, for not more than two years, subject to withdrawal in sums of not less than $100. At any time during such two year period the payee designated in the original election of this option may direct that any unpaid sum remaining with the Company, together with accrued interest thereon, be applied under any other optional method of settlement available under this policy. Any unpaid sum which has not been so applied at the end of such two year period will then be paid in a single sum.

Additional Interest Under Options 2, 3 and 6. The tables for Options 2, 3 and 6 are based on an interest rate of 3% per annum. The payment due on each anniversary of the due date of the first payment will be increased during the specified period of Option 2, or the certain period or instalment refund period of Option 3 or 6, by any additional interest as determined by the Company at the rate declared each year under the option, on the commuted value of the remaining payments for the applicable period.

Election of Options. Election of an optional method of settlement must be made by written notice in form satisfactory to the Company. While the policy is in force during the Insured's lifetime, a previous election can similarly be revoked or changed. Such election, revocation or change will, upon being recorded by the Company at its Home Office, take effect as of the date it was signed, whether or not the Insured is living when it is recorded, subject to any payment made or other action taken by the Company before such recording. An assignee cannot elect an optional method of settlement for unmatured death benefit proceeds nor revoke or change an election previously made.

An election for settlement of death benefit proceeds under these Optional Methods of Settlement provisions can be made by the person entitled to such proceeds if no previous election was in effect at the time of the Insured's death. Such election must be made before payment of the death benefit proceeds and within six months after the Insured's death. An election for settlement of matured endowment proceeds must be made within sixty days of maturity of this policy and an election for settlement of cash value proceeds must be made upon surrender of this policy.

Payee Not a Natural Person Taking in Own Right. Notwithstanding anything in these Optional Methods of Settlement provisions to the contrary, anyone, whether a natural person or not, who has the right to elect an optional method of settlement and who is acting for the benefit of the Insured, or the spouse, child or parent of the Insured, can elect to have death benefit, matured endowment or cash value proceeds settled under Option 2 or 5 or under Option 3 with amount and duration of payments based on the life of the person for whose benefit the election was made. In such case, either the person making the election or the person for whose benefit the election was made may be the payee, as elected.

In addition, any person, other than a natural person, who has the right to elect an optional method of settlement and who is taking in its own right, can elect to have death benefit, matured endowment or cash value proceeds settled under Option 2 or 5 or can elect to have matured endowment or cash value proceeds settled under Option 3 with amount and duration of payments based on the Insured's life. In any of these cases, either the person making such election or the Insured may be the payee, as elected.

Policy Assigned as Collateral. Any amount payable under this policy to a collateral assignee will be paid in a single sum but any remainder of the policy proceeds can be settled in accordance with these Optional Methods of Settlement provisions.

NAME(S) ______________________________

DATE ______________________________

EIGHT-STEP PROCEDURE

1 *Funeral, Administrative, and Estate Tax Expenses* __________

2 *Debt Resolution* (excluding home mortgage) __________

3 *Contingency Fund* (twice your monthly take-home pay) __________

4 *College Fund* __________

5 *NET ANNUAL LIVING EXPENSES*

- A. Average annual living expenses __________
- B. Spouse's average annual income __________
- C. Average annual Social Security __________
- D. Net annual income needs (A – B – C) __________
- E. Number of years in period __________
- F. Average annual investment rate factor (Table 9-1) __________
- G. TOTAL NET INCOME NEEDS (D x F) __________

6 *TOTAL MONETARY NEEDS* (1 + 2 + 3 + 4 + 5G) __________

7 *TOTAL INVESTMENT ASSETS* __________

8 *Your Life Insurance Needs* (6 – 7) __________

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SHOPPING FOR LIFE INSURANCE

	Insurer 1	Insurer 2	Insurer 3
Policy type	________	________	________
Company	________	________	________
Face amount	$________	$________	$________
Net annual premium	$________	$________	$________
Disability waiver of premium	$________	$________	$________
Accidental death and dismemberment rider	$________	$________	$________
Policy owner	________	________	________
Beneficiary	________	________	________
Dividend option[a]	________	________	________

[a] Dividend code: (1) reduces premium, (2) accumulates with interest, (3) purchases paid-up additions, (4) purchases one-year term insurance, (5) paid in cash.

SHOPPING FOR LIFE INSURANCE

	Insurer 1	Insurer 2	Insurer 3
Policy type	________	________	________
Company	________	________	________
Face amount	$________	$________	$________
Net annual premium	$________	$________	$________
Disability waiver of premium	$________	$________	$________
Accidental death and dismemberment rider	$________	$________	$________
Policy owner	________	________	________
Beneficiary	________	________	________
Dividend option[a]	________	________	________

[a] Dividend code: (1) reduces premium, (2) accumulates with interest, (3) purchases paid-up additions, (4) purchases one-year term insurance, (5) paid in cash.

10 · Federal Income Taxes on Individuals

PERFORMANCE OBJECTIVES

After studying this chapter, you should be able to:

- Describe in general how an individual's federal income tax is computed using gross income, deductions, exemptions, and credits.
- Explain how withholding and the estimated tax procedure work and why they are needed.
- Explain the difference between a progressive tax and a regressive tax and how inflation increases the burden imposed by a progressive tax.
- Define *marginal tax rate* and explain how it can be used in making financial decisions, particularly those involving capital gains.
- Describe the legal methods of reducing one's income taxes—income averaging, income splitting, and tax shelters—and the difficulties in profiting from the latter method.
- Describe the various alternatives for preparation of one's tax return.
- Describe what a taxpayer should do if audited.
- Describe the Social Security taxes and how they are assessed.

OUTLINE OF THE MAIN IDEAS

I. U.S. income tax laws are complicated because (1) the sources and nature of our incomes are complex, (2) the tax laws are designed not just for revenue raising but to achieve social and economic purposes, and (3) lobbyists of special interest groups are active.

II. Gross income (all income not expressly tax exempt) is the starting point for computing one's income tax.

   A. Excluded from gross income are proceeds from insurance; other exclusions are not easily categorized but may be found in Publication 17 of the IRS published by the Government Printing Office.

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III. There are two types of deductions, expenses that may reduce the amount of income to be taxed.

A. Deductions taken from gross income (to yield adjusted gross income) are generally derived from business expenses and must be itemized in the tax return.

B. Deductions may also be taken from adjusted gross income (AGI).

1. You may use the *zero bracket amount,* which is $3,400 on a joint return or $2,300 on a single or head-of-household return.

2. You may also itemize deductions and take them to the extent that they exceed the zero bracket amount.

3. Procedure for determining whether you have itemized deductions in excess of the zero bracket amount:

a. Know the major categories of deductions that may be itemized, such as charitable contributions; interest expenses; nonfederal taxes; and medical, dental, and hospital expenses.

b. Keep records throughout the year for each of these.

c. If your itemized deductions when subtracted from the zero bracket amount are still greater than that amount, itemizing your deductions will result in a larger deduction from AGI than just the zero bracket amount. (You may want to prepay or postpone certain payments so that you can take just the zero bracket amount one year and itemized deductions the second if doing so will reduce your taxable income.)

IV. Exemptions ($1,000 each in 1980) are amounts that can be deducted from your income before exemptions to arrive at taxable income.

A. You are allowed an exemption for yourself, for your spouse in a joint return, another for either or both when they reach 65, another for blindness, and one for each dependent.

B. The dependent must be recognized as such by law, have over 50 percent of support from the taxpayer, and have gross annual income lower than the level at which he or she would be required to file a return ($1,000 in 1980).

V. Credits are deductions *from the tax* resulting from some specified expenses. A common one is 20 percent of child-care expenses for working parents (not to exceed $400 for one child or $800 for two or more children). Other credits are outlined in Publication 17.

VI. The actual tax owed is computed on taxable income.

A. Most taxpayers use one of the four Tax Tables, which have zero bracket deductions and exemptions built into them. Taxpayers with high AGIs and excess itemized deductions use the Tax Rate Schedules.

B. All U.S. citizens, including minors, and all aliens living in the United States must file by April 15 each year if their gross incomes for the preceding year exceeded certain limits (see Table 10-1). U.S. citizens living abroad and nonresident aliens who have earned money in the United States must file by June 15 each year if their gross incomes for the preceding year exceeded these limits.

C. If you are married, you may file either way. If one spouse has little or no income, a joint return results in a lower tax. Surviving spouses may elect either return for the year in which their spouse dies but should consult an attorney for the effect on estate settlement.

D. The basic tax return is Form 1040 or 1040A. Certain schedules may also need to be included.

VII. The usual way of paying taxes is by withholding. One's employer holds back a portion (based on one's gross pay for the period and the number of exemptions one claims) of each paycheck and sends it to the IRS within three business days or up to three months, depending upon the amount.

VIII. Estimated taxes (paid quarterly) provide the federal government with immediate revenue from income (such as interest and dividends) not subject to withholding.

A. Form 1040 ES must be filed by April 15 of the current year if you can reasonably expect that your total tax will be $100 greater than the amount withheld by your employer.

B. You must file if you can expect more than $500 in nonwage earnings or if your gross income will be wages subject to withholding exceeding:

1. $20,000 and you are unmarried, a surviving spouse entitled to special tax rates, a head of household or married to a spouse with no earned income

2. $10,000 and you are married to a spouse with earned income

3. $5,000 and you are married but not entitled to file jointly

C. Compute your estimated tax as follows:
  1. Estimate income deductions and exemptions for this year.
  2. Using the Tax Table or Schedule, compute your tax.
  3. Add any self-employment tax to the above.
  4. Deduct the amount expected to be withheld by your employer plus any tax credits from the amount of step 3.
  5. The remainder is your estimated tax. If it is less than $100, you need not file. If it is over $100, divide it by four and pay it on April 15, June 15, and September 15 of the current year and January 15 of the next year.

D. Underpayments are penalized by 6 percent on the delinquency. The delinquent amount is the difference between 80 percent of what should have been paid and the amount actually paid.

IX. Taxes are levied on a capital gain—the gain, after commissions and fees, resulting from the sale or exchange of a capital asset (such as real estate, stocks and bonds, jewelry).

A. A long-term (l.t.) capital gain occurs when an asset has been owned for more than one year; otherwise, it is short-term (s.t.). Only 40 percent of a long-term capital gain must be included in taxable income. This tax break is to encourage people to invest in capital assets and not penalize them with high income tax rates.

B. The computation procedure consists of five steps.
  1. Determine whether the gain or loss qualifies for tax treatment. All gains must be included in income. All losses except those from the sale of a house or personal possessions may be deducted from income although these might have to be taken over a period of years.
  2. Determine the amount of gain or loss by adjusting the original cost to include expenses incurred in buying and selling it and any improvements you made on it; subtract this from the proceeds of the sale.
  3. Determine whether it is a s.t. or l.t. gain or loss.
  4. Determine the net s.t. gain or loss by subtracting all s.t. losses from s.t. gains.
  5. Use the same procedure as in step 4 for l.t. gains and losses.

C. These seven guidelines tell how to use net gains and losses in determining gross income and the capital gains tax.
  1. When a net s.t. gain is greater than a net l.t. loss, all the excess should be included in gross income.
  2. When there is a net s.t. gain and no net l.t. loss, the entire gain is gross income.
  3. When a net s.t. loss is greater than a net l.t. gain, the excess (up to $3,000) is deducted from gross income. Any remainder is carried forward to the next year when it is offset first against net s.t. gains, then against net l.t. gains, then against $3,000 of gross income; this is done each year until the excess is exhausted. These carry forwards are shown in Schedule D.
  4. When there is a net s.t. loss and no net l.t. gain, the amount of loss (up to $3,000) is deducted from gross income. Any excess is carried forward as in guideline 3.
  5. When a net l.t. gain is greater than a net s.t. loss, only 40 percent of the excess is included in gross income.
  6. When there is a net l.t. gain and no net s.t. loss, only 40 percent of the gain is included in gross income.
  7. When there is a net l.t. loss greater than a net s.t. gain, 50 percent of the excess (up to $3,000) is deducted from gross income. Any remainder is carried forward to the next year when it is offset first against net l.t. gains, then net s.t. gains, then up to $3,000 of gross income, and so on for the remaining years until it is exhausted.

D. There is no tax if you buy or start to build another home within the period from 18 months before the sale to 18 months after.
  1. You will be taxed on the amount of the proceeds not used for such a purchase.
  2. If you are 55 or over, you have a once-in-your-lifetime choice to exclude $100,000 of the gain from taxation.

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X. Federal income tax is progressive: the more income you make, the higher the percentage that is taken in taxes.
   - A. The tax bracket you are in is the spread of income, such as $11,900 to $16,000, which determines your tax rate.
   - B. The Social Security tax is proportional: the tax rate is the same for all. It is regressive in that it is levied only up to a certain amount ($25,900 in 1980); it affects poorer people more than richer people.
   - C. Two dangers of progressive taxes are that they tend to discourage capital investment and to lessen the incentive to work.
   - D. A marginal tax rate is the highest tax rate at which, given a specified income level, any added income is taxed.
     1. It is used to determine the tax effect of additional income or deductible expense. A marginal tax rate of 21 percent, for example, means that for every added dollar of deductible expense, you save 21¢ in taxes.
     2. It is computed as the difference in the Tax Table tax for one's income and the Tax Table tax for one's income plus $100.
   - E. As inflation causes a decline in the purchasing power of the dollar, attempts to keep up with inflation drive the taxpayer into higher brackets. Congress tried to deal with this by increasing the personal exemption from $750 to $1,000 and widening the tax brackets.

XI. There are several ways to legally reduce one's taxes.
   - A. Hold capital assets until they become long-term.
   - B. Use depreciation in real estate investments (to be discussed in Chapter 20).
   - C. Income averaging is used by people whose incomes fluctuate greatly. To determine whether to use income averaging once you have computed your taxable income:
     1. Take the sum of your taxable incomes for the previous four years, not including the current year.
     2. Multiply this by 30 percent.
     3. Add $3,000 to this. If your current year's income is greater than this amount, income averaging may be appropriate for you and you should seek assistance in using it.
   - D. Income splitting shifts income from a person in a high bracket to one in a lower bracket by means of a gift.

XII. High tax rates for the rich do not necessarily increase the tax revenues from them because of the resulting economic disincentives to earn more money. The greatest amount of taxes is paid by the middle class.
   - A. Tax shelters are investments made for the purpose of deriving deductions that may be offset against the investor's income.
     1. There are only three real shelters that allow taxes to be avoided permanently: (a) the conversion of ordinary income into long-term capital gains through depreciation, (b) the depletion allowance for mineral, oil, and gas investments, and (c) the investment tax credit.
     2. Other tax shelters only defer taxes to the future, but since the investments incur risk, the gain saved in taxes could be offset by losses in the investment.
   - B. The minimum income tax is designed to prevent rich persons and corporations from escaping taxes from investments that enjoy preferential tax treatment (such as amortization of railroad rolling stock). The minimum tax of 15 percent is levied on the value of these tax preferences where they exceed $10,000 or a deduction of half the regular income taxes due for that year, whichever is greater.

XIII. There are several alternatives in tax return preparation, although the tax laws are so complex that even professionals make mistakes.
   - A. If your returns are fairly simple and you enjoy it, you may do it yourself with the help of Publication 17 and other guides that are not so IRS-biased.

B. The IRS will do it for you if you meet these qualifications:
   1. Your AGI is $20,000 or less ($40,000 or less for joint returns).
   2. Your income comes only from wages, salaries, tips, pensions, annuities, dividends and/or interest.
   3. You do not itemize deductions against AGI.
   4. You do not use income averaging.
   5. You file by April 15.

C. Varying degrees of expertise can be had at varying prices.
   1. CPAs and tax attorneys are the most knowledgeable and should be used only for complicated situations.
   2. Public accountants should be used only if they have passed the nine-hour exam; you can get their names from your district IRS.
   3. National tax services are suitable for situations too complex for the ordinary taxpayer but too simple to justify the fees of a CPA or tax attorney.
   4. Local tax services may lack the motivation of the national tax services to protect their reputation.

D. The Tax Reform Act of 1976 specifies that a professional tax preparer must:
   1. Sign each return prepared and include his or her Social Security number or employer's tax ID number.
   2. Give the taxpayer a copy of the return no later than the time the return is presented for signing.
   3. Keep a copy of the return for three years after the year for which it was prepared.
   4. Regularly file with the IRS information on his or her activities and, if an employer, on the activities of employees.
   5. Not negotiate refund checks for taxpayers to pay fees or the like.

XIV. If you observe certain filing dates and other requirements, your relations with the IRS should remain good.
   A. There are penalties for late filing, underpayment, negligence, and fraud.
   B. If the computer picks up an irregularity in your return and the IRS chooses to audit it, you should try to resolve the issues first with the agent or other IRS personnel. When up to $5,000 in taxes is disputed, you may petition to have your case heard by the IRS Small Case Tax Court; decisions of the court may not be appealed. The federal courts are a possibility next, but be sure to assess your chances of winning and the costs beforehand.

XV. Social Security taxes include those paid by employees and their employers to fund disability, death, and retirement benefits (FICA), those paid by self-employed persons for the same purpose (SETA), and those paid by employers to fund unemployment benefits (FUTA).

XVI. In addition to income taxes, taxes are also levied on such things as the sale of certain items and real property.

SELF-TESTING EXERCISES

True-False

_____ 1. Few tax reduction strategies are of value even to wealthy people.

_____ 2. Gross income includes all income not expressly excluded by law.

_____ 3. Alimony payments may not be deducted from gross income.

_____ 4. The zero bracket amount for a single head-of-household return is $3,200.

_____ 5. Itemized deductions may be subtracted from AGI to the extent that they exceed the zero bracket amount.

______ 6. To get maximum value from itemized deductions, you might prepay them and take them that year, or defer payment and take the zero bracket amount in that year.

______ 7. A long-term capital gain occurs on gains from assets held more than six months.

______ 8. If you are age 55 or over, you can exclude $100,000 of the capital gain from the sale of your home.

______ 9. Both the federal income tax and Social Security taxes are progressive.

______ 10. Most tax shelters avoid taxes permanently.

Completion

1. ______________________ includes all income not expressly excluded by law.
2. Taxpayers who file a joint return may deduct from adjusted gross income $3,400 as the ______________ ______________________ amount.
3. Medical and dental expenses in excess of ______________________ percent of AGI may be deducted from AGI.
4. Casualty and theft losses above $______________________ are tax deductible.
5. The Maloneys both work. They paid $2,500 in child-care expense for their three children. Their tax credit is $______________________.
6. Only ______________________ percent of a realized long-term capital gain must be included in ordinary income.
7. The highest tax rate at which, given a particular income level, any additional income is taxed is the ______________________ rate.
8. If your income fluctuates substantially from year to year, you should consider ______________________ ______________________ to reduce taxes.
9. Investments that allow investors to derive deductions that can be offset against their income are called ______________________.
10. ______________________ and tax attorneys have the most extensive training and experience in tax matters.

Multiple Choice

1. Your taxable income for the last four years is $11,800, $13,200, $12,700, $15,400. Your current year's income must exceed what amount to qualify for income averaging?

   a. $11,921
   b. $15,930
   c. $18,921
   d. $18,930
   e. $21,930

2. You are in the 28 percent marginal income tax bracket. An additional $750 of income will increase your taxes

   a. $28
   b. $75
   c. $210
   d. $287
   e. $758

3. A surviving spouse files a separate return if his or her gross income exceeds

   a. $1,000
   b. $1,500
   c. $4,400
   d. $5,400
   e. $7,400

4. Married persons filing a joint return must do so if their gross income exceeds

   a. $1,000
   b. $1,500
   c. $4,400
   d. $5,400
   e. $7,400

5. Which of the following is NOT an element of the income tax computation procedure?

   a. Annotated gross tax
   b. Gross income
   c. Exemption
   d. Adjusted gross income
   e. Itemized deduction

6. The average taxpayer seeking professional assistance with preparation of his or her tax return should probably go first to a

   a. tax attorney
   b. public accountant
   c. CPA
   d. local tax service

7. Which of the following would NOT qualify as an itemized deduction against adjusted gross income?

   a. Medical expenses
   b. Business expenses
   c. Charitable contributions
   d. Nonfederal taxes
   e. Interest expenses

8. Separate returns may be used by

   a. minors
   b. aliens
   c. heads of households
   d. widows
   e. (All of the above)

9. Which of the following persons must file an income tax return?

   a. U.S. citizens living abroad
   b. Aliens living in this country
   c. U.S. citizens living in this country
   d. (All of the above)

Cases and Problems

1. Suppose you are a single taxpayer with no dependents and have the following itemized deductions against adjusted gross income of $14,000 (from line 31, Form 1040):

Medicines	$ 180
Medical expenses	900
Dental expenses	550
Real estate taxes	1,000
State income taxes	1,900
General sales tax	500
Gasoline tax	70
Home mortgage interest	3,500
Cash contributions	400
Union dues	150
Health insurance premium	100

Complete Schedule A (page 96).

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2. In addition to the information calculated in the last problem, you have the following tax considerations:

Salary (Income averaging does not apply.)	$15,000
Interest income	100
Dividends (net of $100 exclusion)	300
Moving expenses	1,400
Withheld income taxes	2,000
One exemption for yourself	

Now complete Form 1040 (pages 97-98). You will need to use also Tax Table A (pages 99-100).

a. Do you owe more in taxes than was withheld? If so, how much?
b. Does the IRS owe you money? If so, how much?
c. What are your options as to what to do with any refund?

PERSONAL MONEY MANAGEMENT ACTIVITIES

A. Look up your tax files or your parents' over the last five years.

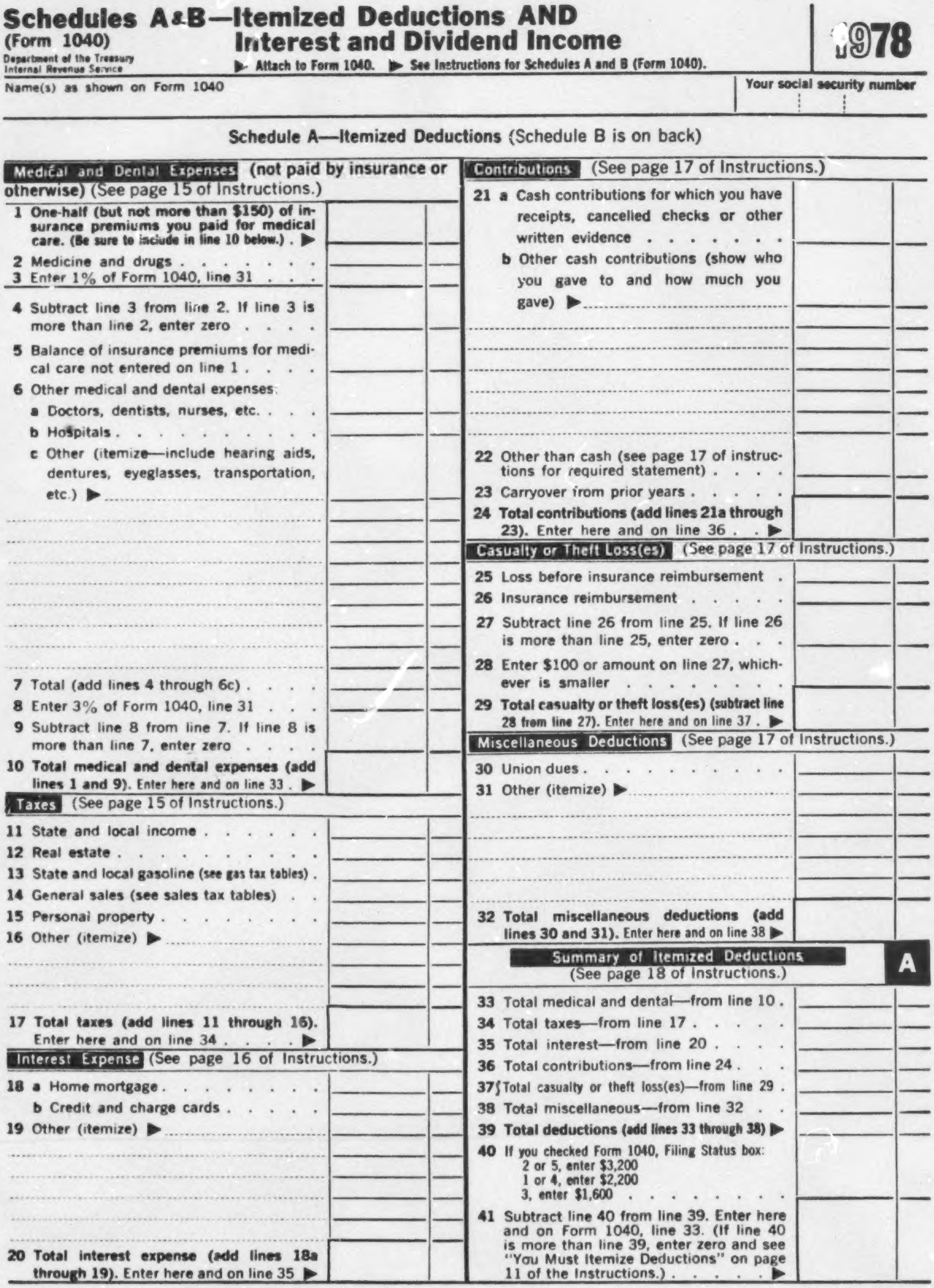
1. What is the percentage increase in gross income over five years ago?
2. What was the amount of the exemption five years ago?
3. Was there a zero bracket amount then? And if not, what was then similar to it?
4. Has the form become more or less complicated?

B. Call three tax preparers and ask about their credentials and experience. From your conversations, determine and compare the costs and benefits of using them to prepare your tax return.

ADDITIONAL ACTIVITIES

A. In a letter to your representative to Congress ask what ideas or plans the person has for changing the income tax structure or procedure.

B. Ask a representative of your local IRS to explain how tax returns are audited and what recourse you have when your return is questioned.



Schedules A&B—Itemized Deductions AND Interest and Dividend Income

(Form 1040)

Department of the Treasury
Internal Revenue Service

▶ Attach to Form 1040. ▶ See Instructions for Schedules A and B (Form 1040).

1978

Name(s) as shown on Form 1040

Your social security number

Schedule A—Itemized Deductions (Schedule B is on back)

Medical and Dental Expenses (not paid by insurance or otherwise) (See page 15 of Instructions.)

1 One-half (but not more than $150) of insurance premiums you paid for medical care. (Be sure to include in line 10 below.) . ▶
2 Medicine and drugs . . . .
3 Enter 1% of Form 1040, line 31 . . .
4 Subtract line 3 from line 2. If line 3 is more than line 2, enter zero . . . .
5 Balance of insurance premiums for medical care not entered on line 1 . . . .
6 Other medical and dental expenses:
a Doctors, dentists, nurses, etc. . . .
b Hospitals . . . .
c Other (itemize—include hearing aids, dentures, eyeglasses, transportation, etc.) ▶
7 Total (add lines 4 through 6c) . . . .
8 Enter 3% of Form 1040, line 31 . . .
9 Subtract line 8 from line 7. If line 8 is more than line 7, enter zero . . . .
10 Total medical and dental expenses (add lines 1 and 9). Enter here and on line 33 . ▶

Taxes (See page 15 of Instructions.)

11 State and local income . . . . . .
12 Real estate . . . .
13 State and local gasoline (see gas tax tables) .
14 General sales (see sales tax tables) . .
15 Personal property . . . .
16 Other (itemize) ▶
17 Total taxes (add lines 11 through 16). Enter here and on line 34 . . . . ▶

Interest Expense (See page 16 of Instructions.)

18 a Home mortgage . . . .
b Credit and charge cards . . . . .
19 Other (itemize) ▶
20 Total interest expense (add lines 18a through 19). Enter here and on line 35 ▶

Contributions (See page 17 of Instructions.)

21 a Cash contributions for which you have receipts, cancelled checks or other written evidence . . . .
b Other cash contributions (show who you gave to and how much you gave) ▶
22 Other than cash (see page 17 of instructions for required statement) . . . .
23 Carryover from prior years . . . . .
24 Total contributions (add lines 21a through 23). Enter here and on line 36 . . ▶

Casualty or Theft Loss(es) (See page 17 of Instructions.)

25 Loss before insurance reimbursement .
26 Insurance reimbursement . . . . .
27 Subtract line 26 from line 25. If line 26 is more than line 25, enter zero . . .
28 Enter $100 or amount on line 27, whichever is smaller . . . .
29 Total casualty or theft loss(es) (subtract line 28 from line 27). Enter here and on line 37 . ▶

Miscellaneous Deductions (See page 17 of Instructions.)

30 Union dues . . . .
31 Other (itemize) ▶
32 Total miscellaneous deductions (add lines 30 and 31). Enter here and on line 38 ▶

Summary of Itemized Deductions
(See page 18 of Instructions.)

A

33 Total medical and dental—from line 10 .
34 Total taxes—from line 17 . . . . .
35 Total interest—from line 20 . . . .
36 Total contributions—from line 24 . . .
37 Total casualty or theft loss(es)—from line 29 .
38 Total miscellaneous—from line 32 . .
39 Total deductions (add lines 33 through 38) ▶
40 If you checked Form 1040, Filing Status box:
2 or 5, enter $3,200
1 or 4, enter $2,200
3, enter $1,600 . . . .
41 Subtract line 40 from line 39. Enter here and on Form 1040, line 33. (If line 40 is more than line 39, enter zero and see "You Must Itemize Deductions" on page 11 of the Instructions.) . . . . . ▶

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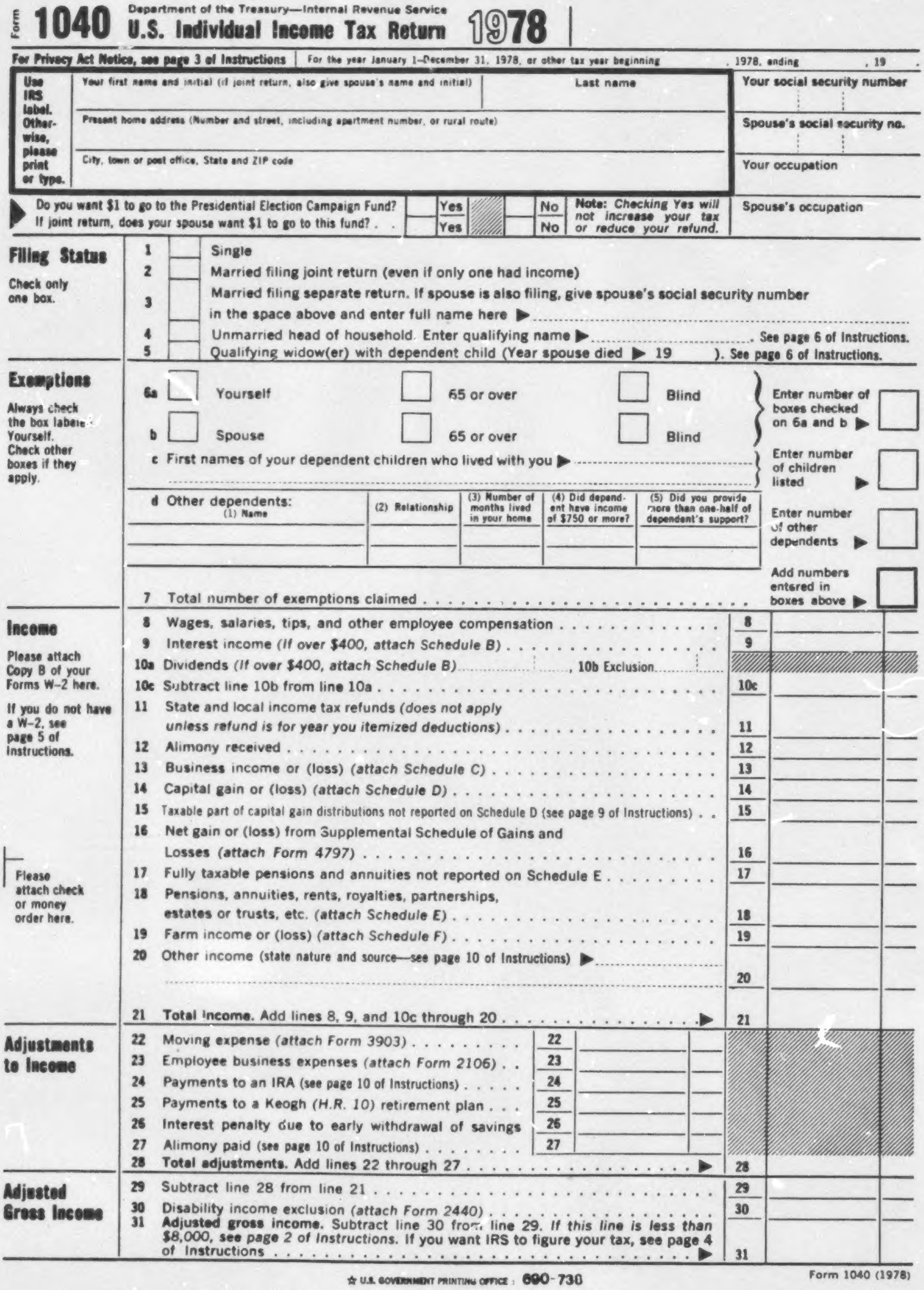

Form **1040** Department of the Treasury—Internal Revenue Service
U.S. Individual Income Tax Return **1978**

For Privacy Act Notice, see page 3 of Instructions | For the year January 1–December 31, 1978, or other tax year beginning , 1978, ending , 19 .

Use IRS label. Otherwise, please print or type.	Your first name and initial (if joint return, also give spouse's name and initial)	Last name	**Your social security number**
	Present home address (Number and street, including apartment number, or rural route)		**Spouse's social security no.**
	City, town or post office, State and ZIP code		**Your occupation**

▶ Do you want $1 to go to the Presidential Election Campaign Fund? ☐ Yes ☐ No
If joint return, does your spouse want $1 to go to this fund? . . ☐ Yes ☐ No
Note: *Checking Yes will not increase your tax or reduce your refund.*
Spouse's occupation

Filing Status

Check only one box.

1 ☐ Single
2 ☐ Married filing joint return (even if only one had income)
3 ☐ Married filing separate return. If spouse is also filing, give spouse's social security number in the space above and enter full name here ▶
4 ☐ Unmarried head of household. Enter qualifying name ▶ See page 6 of Instructions.
5 ☐ Qualifying widow(er) with dependent child (Year spouse died ▶ 19). See page 6 of Instructions.

Exemptions

Always check the box labeled Yourself. Check other boxes if they apply.

6a ☐ Yourself ☐ 65 or over ☐ Blind
b ☐ Spouse ☐ 65 or over ☐ Blind
Enter number of boxes checked on 6a and b ▶ ☐

c First names of your dependent children who lived with you ▶
Enter number of children listed ▶ ☐

d Other dependents: (1) Name	(2) Relationship	(3) Number of months lived in your home	(4) Did dependent have income of $750 or more?	(5) Did you provide more than one-half of dependent's support?

Enter number of other dependents ▶ ☐

7 Total number of exemptions claimed . . . . Add numbers entered in boxes above ▶ ☐

Income

Please attach Copy B of your Forms W-2 here.

If you do not have a W-2, see page 5 of Instructions.

Please attach check or money order here.

8	Wages, salaries, tips, and other employee compensation	8	
9	Interest income *(If over $400, attach Schedule B)*	9	
10a	Dividends *(If over $400, attach Schedule B)* ...., 10b Exclusion........		▨
10c	Subtract line 10b from line 10a	10c	
11	State and local income tax refunds *(does not apply unless refund is for year you itemized deductions)*	11	
12	Alimony received	12	
13	Business income or (loss) *(attach Schedule C)*	13	
14	Capital gain or (loss) *(attach Schedule D)*	14	
15	Taxable part of capital gain distributions not reported on Schedule D (see page 9 of Instructions) . .	15	
16	Net gain or (loss) from Supplemental Schedule of Gains and Losses *(attach Form 4797)*	16	
17	Fully taxable pensions and annuities not reported on Schedule E	17	
18	Pensions, annuities, rents, royalties, partnerships, estates or trusts, etc. *(attach Schedule E)*	18	
19	Farm income or (loss) *(attach Schedule F)*	19	
20	Other income (state nature and source—see page 10 of Instructions) ▶	20	
21	**Total income.** Add lines 8, 9, and 10c through 20 . . . . ▶	21	

Adjustments to Income

22	Moving expense *(attach Form 3903)*	22			▨
23	Employee business expenses *(attach Form 2106)* . .	23			▨
24	Payments to an IRA (see page 10 of Instructions)	24			▨
25	Payments to a Keogh *(H.R. 10)* retirement plan . . .	25			▨
26	Interest penalty due to early withdrawal of savings	26			▨
27	Alimony paid (see page 10 of Instructions)	27			▨
28	**Total adjustments.** Add lines 22 through 27 . . . . ▶			28	

Adjusted Gross Income

29	Subtract line 28 from line 21	29	
30	Disability income exclusion *(attach Form 2440)*	30	
31	**Adjusted gross income.** Subtract line 30 from line 29. *If this line is less than $8,000, see page 2 of Instructions. If you want IRS to figure your tax, see page 4 of Instructions* . . . . ▶	31	

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Form 1040 (1978)

Form 1040 (1978) Page 2

Tax Computation

32 Amount from line 31 32

33 If you do not itemize deductions, enter zero . . . .
If you itemize, complete Schedule A (Form 1040) and enter the amount from Schedule A, line 41 33

Caution: If you have unearned income and can be claimed as a dependent on your parent's return, check here ▶ ☐ and see page 11 of the Instructions. Also see page 11 of the Instructions if:

- *You are married filing a separate return and your spouse itemizes deductions, OR*
- *You file Form 4563, OR*
- *You are a dual-status alien.*

34 Subtract line 33 from line 32. Use the amount on line 34 to find your tax from the Tax Tables, or to figure your tax on Schedule TC, Part I 34
Use Schedule TC, Part I, and the Tax Rate Schedules ONLY if:

- *The amount on line 34 is more than $20,000 ($40,000 if you checked Filing Status Box 2 or 5), OR*
- *You have more exemptions than those covered in the Tax Table for your filing status, OR*
- *You use any of these forms to figure your tax: Schedule D, Schedule G, or Form 4726.*

Otherwise, you MUST use the Tax Tables to find your tax.

35 Tax. Enter tax here and check if from ☐ Tax Tables or ☐ Schedule TC 35

36 Additional taxes. (See page 11 of Instructions.) Enter total and check if from ☐ Form 4970, ☐ Form 4972, ☐ Form 5544, ☐ Form 5405, or ☐ Section 72(m)(5) penalty tax . . . 36

37 **Total.** Add lines 35 and 36 . . . . ▶ 37

Credits

38 Credit for contributions to candidates for public office . . 38

39 Credit for the elderly *(attach Schedules R&RP)* 39

40 Credit for child and dependent care expenses (attach Form 2441) . 40

41 Investment credit *(attach Form 3468)* 41

42 Foreign tax credit *(attach Form 1116)* 42

43 Work Incentive (WIN) Credit *(attach Form 4874)* 43

44 New jobs credit *(attach Form 5884)* 44

45 Residential energy credits (see page 12 of Instructions, attach Form 5695) . . . 45

46 **Total credits.** Add lines 38 through 45 46

47 **Balance.** Subtract line 46 from line 37 and enter difference (but not less than zero) . ▶ 47

Other Taxes

48 Self-employment tax *(attach Schedule SE)* 48

49 Minimum tax. Check here ▶ ☐ and attach Form 4625 49

50 Tax from recomputing prior-year investment credit *(attach Form 4255)* 50

51 Social security (FICA) tax on tip income not reported to employer *(attach Form 4137)* . . 51

52 Uncollected employee FICA and RRTA tax on tips *(from Form W–2)* 52

53 Tax on an IRA *(attach Form 5329)* 53

54 **Total tax.** Add lines 47 through 53 . . . . ▶ 54

Payments

Attach Forms W–2, W–2G, and W–2P to front.

55 Total Federal income tax withheld 55

56 1978 estimated tax payments and credit from 1977 return . 56

57 Earned income credit. If line 31 is under $8,000, see page 2 of Instructions. **If eligible, enter child's name** ▶ 57

58 Amount paid with Form 4868 58

59 Excess FICA and RRTA tax withheld (two or more employers) 59

60 Credit for Federal tax on special fuels and oils (attach Form 4136) . 60

61 Regulated Investment Company credit *(attach Form 2439)* 61

62 **Total.** Add lines 55 through 61 . . . . ▶ 62

Refund or Due

63 If line 62 is larger than line 54, enter amount **OVERPAID** . . . . ▶ 63

64 Amount of line 63 to be **REFUNDED TO YOU** . . . . ▶ 64

65 Amount of line 63 to be credited on 1979 estimated tax . ▶ 65

66 If line 54 is larger than line 62, enter **BALANCE DUE.** Attach check or money order for full amount payable to "Internal Revenue Service." Write your social security number on check or money order . . ▶ 66
(Check ▶ ☐ if Form 2210 (2210F) is attached. See page 14 of instructions.) ▶ $

Please Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

▶ Your signature Date

▶ Spouse's signature (if filing jointly, BOTH must sign even if only one had income)

Paid Preparer's Information

Preparer's signature ▶

Preparer's social security no.

Check if self-employed ▶ ☐

Firm's name (or yours, if self-employed), address and ZIP code ▶

E.I. No. ▶

Date ▶

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1978 Tax Table A—SINGLE (Filing Status Box 1)

(For single persons with income of $20,000 or less on Form 1040, line 34, who claim 3 or fewer exemptions)

To find your tax: Read down the income column until you find your income as shown on Form 1040, line 34. Read across to the column headed by the total number of exemptions claimed on Form 1040, line 7. The amount shown where the two lines meet is your tax. Enter on Form 1040, line 35. The $2,200 zero bracket amount, your deduction for exemptions and the general tax credit have been taken into account in figuring the tax shown in this table. **Do not take a separate deduction for them.**

Caution: *If you can be claimed as a dependent on your parent's return* **AND** *you have unearned income (interest, dividends, etc.) of $750 or more* **AND** *your earned income is less than $2,200, you must first use Schedule TC (Form 1040), Part II.*

If Form 1040, line 34, is—		And the total number of exemptions claimed on line 7 is—		
Over	But not over	1	2	3
		Your tax is—		
If $3,200 or less your tax is 0				
3,200	3,250	4	0	0
3,250	3,300	11	0	0
3,300	3,350	18	0	0
3,350	3,400	25	0	0
3,400	3,450	32	0	0
3,450	3,500	39	0	0
3,500	3,550	46	0	0
3,550	3,600	54	0	0
3,600	3,650	61	0	0
3,650	3,700	69	0	0
3,700	3,750	76	0	0
3,750	3,800	84	0	0
3,800	3,850	91	0	0
3,850	3,900	99	0	0
3,900	3,950	106	0	0
3,950	4,000	114	0	0
4,000	4,050	122	0	0
4,050	4,100	130	0	0
4,100	4,150	138	0	0
4,150	4,200	146	0	0
4,200	4,250	154	4	0
4,250	4,300	162	11	0
4,300	4,350	170	19	0
4,350	4,400	178	26	0
4,400	4,450	186	34	0
4,450	4,500	194	41	0
4,500	4,550	203	49	0
4,550	4,600	211	56	0
4,600	4,650	220	64	0
4,650	4,700	228	71	0
4,700	4,750	236	79	0
4,750	4,800	244	87	0
4,800	4,850	251	95	0
4,850	4,900	259	103	0
4,900	4,950	266	111	0
4,950	5,000	274	119	0
5,000	5,050	283	127	0
5,050	5,100	291	135	0
5,100	5,150	300	143	0
5,150	5,200	308	151	0
5,200	5,250	317	159	6
5,250	5,300	325	168	14
5,300	5,350	334	176	21
5,350	5,400	342	185	29
5,400	5,450	351	193	36
5,450	5,500	359	202	44
5,500	5,550	368	210	52
5,550	5,600	376	219	60
5,600	5,650	385	227	68
5,650	5,700	393	236	76
5,700	5,750	402	245	84
5,750	5,800	410	254	92
5,800	5,850	419	264	100
5,850	5,900	427	273	108
5,900	5,950	436	283	116
5,950	6,000	444	292	124
6,000	6,050	453	302	133
6,050	6,100	461	311	141
6,100	6,150	470	321	150
6,150	6,200	478	330	158
6,200	6,250	487	340	167
6,250	6,300	495	349	175
6,300	6,350	504	359	184
6,350	6,400	512	368	192
6,400	6,450	521	378	201
6,450	6,500	529	387	210
6,500	6,550	538	397	219
6,550	6,600	546	406	229
6,600	6,650	555	416	238
6,650	6,700	563	425	248
6,700	6,750	572	435	257
6,750	6,800	580	444	267
6,800	6,850	589	454	276
6,850	6,900	597	463	286
6,900	6,950	606	473	295
6,950	7,000	615	482	305
7,000	7,050	624	492	314
7,050	7,100	634	501	324
7,100	7,150	643	511	333
7,150	7,200	653	520	343
7,200	7,250	662	529	352
7,250	7,300	672	538	362
7,300	7,350	681	546	371
7,350	7,400	691	555	381
7,400	7,450	700	563	390
7,450	7,500	710	572	400
7,500	7,550	719	580	409
7,550	7,600	729	589	419
7,600	7,650	738	597	428
7,650	7,700	748	606	438
7,700	7,750	757	615	447
7,750	7,800	767	624	457
7,800	7,850	776	634	466
7,850	7,900	786	643	476
7,900	7,950	795	653	485
7,950	8,000	805	662	495
8,000	8,050	814	672	504
8,050	8,100	824	681	514
8,100	8,150	833	691	523
8,150	8,200	843	700	533
8,200	8,250	852	710	542
8,250	8,300	862	719	552
8,300	8,350	871	729	561
8,350	8,400	881	738	571
8,400	8,450	890	748	580
8,450	8,500	900	757	590
8,500	8,550	909	767	601
8,550	8,600	919	776	611
8,600	8,650	928	786	622
8,650	8,700	938	795	632
8,700	8,750	947	805	643
8,750	8,800	957	814	653
8,800	8,850	966	824	664
8,850	8,900	976	833	674
8,900	8,950	985	843	685
8,950	9,000	996	852	695
9,000	9,050	1,007	862	706
9,050	9,100	1,018	871	716
9,100	9,150	1,029	881	727
9,150	9,200	1,040	890	737
9,200	9,250	1,051	900	748
9,250	9,300	1,062	909	758
9,300	9,350	1,073	919	769
9,350	9,400	1,084	928	779
9,400	9,450	1,095	938	790
9,450	9,500	1,106	947	800
9,500	9,550	1,117	957	811
9,550	9,600	1,128	966	821
9,600	9,650	1,139	976	832
9,650	9,700	1,150	985	842
9,700	9,750	1,161	996	852
9,750	9,800	1,172	1,007	862
9,800	9,850	1,183	1,018	871
9,850	9,900	1,194	1,029	881
9,900	9,950	1,205	1,040	890
9,950	10,000	1,216	1,051	900
10,000	10,050	1,227	1,062	909
10,050	10,100	1,238	1,073	919
10,100	10,150	1,249	1,084	928
10,150	10,200	1,260	1,095	938
10,200	10,250	1,271	1,106	947
10,250	10,300	1,282	1,117	957
10,300	10,350	1,293	1,128	966
10,350	10,400	1,304	1,139	976
10,400	10,450	1,315	1,150	985
10,450	10,500	1,326	1,161	996
10,500	10,550	1,337	1,172	1,007
10,550	10,600	1,348	1,183	1,018
10,600	10,650	1,359	1,194	1,029
10,650	10,700	1,370	1,205	1,040
10,700	10,750	1,381	1,216	1,051
10,750	10,800	1,392	1,227	1,062
10,800	10,850	1,403	1,238	1,073
10,850	10,900	1,414	1,249	1,084
10,900	10,950	1,425	1,260	1,095
10,950	11,000	1,436	1,271	1,106

Continued on next page

1978 Tax Table A—SINGLE (Filing Status Box 1) *(Continued)*

(If your income or exemptions are not covered, use Schedule TC (Form 1040), Part I to figure your tax)

If Form 1040, line 34, is—		And the total number of exemptions claimed on line 7 is—		
Over	But not over	1	2	3
		Your tax is—		
11,000	11,050	1,447	1,282	1,117
11,050	11,100	1,459	1,293	1,128
11,100	11,150	1,470	1,304	1,139
11,150	11,200	1,482	1,315	1,150
11,200	11,250	1,493	1,326	1,161
11,250	11,300	1,505	1,337	1,172
11,300	11,350	1,516	1,348	1,183
11,350	11,400	1,528	1,359	1,194
11,400	11,450	1,539	1,370	1,205
11,450	11,500	1,551	1,381	1,216
11,500	11,550	1,562	1,392	1,227
11,550	11,600	1,574	1,403	1,238
11,600	11,650	1,585	1,414	1,249
11,650	11,700	1,597	1,425	1,260
11,700	11,750	1,608	1,436	1,271
11,750	11,800	1,620	1,447	1,282
11,800	11,850	1,631	1,459	1,293
11,850	11,900	1,643	1,470	1,304
11,900	11,950	1,654	1,482	1,315
11,950	12,000	1,666	1,493	1,326
12,000	12,050	1,679	1,505	1,337
12,050	12,100	1,691	1,516	1,348
12,100	12,150	1,704	1,528	1,359
12,150	12,200	1,716	1,539	1,370
12,200	12,250	1,729	1,551	1,381
12,250	12,300	1,741	1,562	1,392
12,300	12,350	1,754	1,574	1,403
12,350	12,400	1,766	1,585	1,414
12,400	12,450	1,779	1,597	1,425
12,450	12,500	1,791	1,608	1,436
12,500	12,550	1,804	1,620	1,447
12,550	12,600	1,816	1,631	1,459
12,600	12,650	1,829	1,643	1,470
12,650	12,700	1,841	1,654	1,482
12,700	12,750	1,854	1,666	1,493
12,750	12,800	1,866	1,679	1,505
12,800	12,850	1,879	1,691	1,516
12,850	12,900	1,891	1,704	1,528
12,900	12,950	1,904	1,716	1,539
12,950	13,000	1,917	1,729	1,551
13,000	13,050	1,930	1,741	1,562
13,050	13,100	1,944	1,754	1,574
13,100	13,150	1,957	1,766	1,585
13,150	13,200	1,971	1,779	1,597
13,200	13,250	1,984	1,791	1,608
13,250	13,300	1,998	1,804	1,620
13,300	13,350	2,011	1,816	1,631
13,350	13,400	2,025	1,829	1,643
13,400	13,450	2,038	1,841	1,654
13,450	13,500	2,052	1,854	1,666
13,500	13,550	2,065	1,866	1,679
13,550	13,600	2,079	1,879	1,691
13,600	13,650	2,092	1,891	1,704
13,650	13,700	2,106	1,904	1,716
13,700	13,750	2,119	1,917	1,729
13,750	13,800	2,133	1,930	1,741
13,800	13,850	2,146	1,944	1,754
13,850	13,900	2,160	1,957	1,766
13,900	13,950	2,173	1,971	1,779
13,950	14,000	2,187	1,984	1,791
14,000	14,050	2,200	1,998	1,804
14,050	14,100	2,214	2,011	1,816
14,100	14,150	2,227	2,025	1,829
14,150	14,200	2,241	2,038	1,841
14,200	14,250	2,254	2,052	1,854
14,250	14,300	2,268	2,065	1,866
14,300	14,350	2,281	2,079	1,879
14,350	14,400	2,295	2,092	1,891
14,400	14,450	2,308	2,106	1,904
14,450	14,500	2,322	2,119	1,917
14,500	14,550	2,335	2,133	1,930
14,550	14,600	2,349	2,146	1,944
14,600	14,650	2,362	2,160	1,957
14,650	14,700	2,376	2,173	1,971
14,700	14,750	2,389	2,187	1,984
14,750	14,800	2,403	2,200	1,998
14,800	14,850	2,416	2,214	2,011
14,850	14,900	2,430	2,227	2,025
14,900	14,950	2,443	2,241	2,038
14,950	15,000	2,457	2,254	2,052
15,000	15,050	2,472	2,268	2,065
15,050	15,100	2,486	2,281	2,079
15,100	15,150	2,501	2,295	2,092
15,150	15,200	2,515	2,308	2,106
15,200	15,250	2,530	2,322	2,119
15,250	15,300	2,544	2,335	2,133
15,300	15,350	2,559	2,349	2,146
15,350	15,400	2,573	2,362	2,160
15,400	15,450	2,588	2,376	2,173
15,450	15,500	2,602	2,389	2,187
15,500	15,550	2,617	2,403	2,200
15,550	15,600	2,631	2,416	2,214
15,600	15,650	2,646	2,430	2,227
15,650	15,700	2,660	2,443	2,241
15,700	15,750	2,675	2,457	2,254
15,750	15,800	2,689	2,472	2,268
15,800	15,850	2,704	2,486	2,281
15,850	15,900	2,718	2,501	2,295
15,900	15,950	2,733	2,515	2,308
15,950	16,000	2,747	2,530	2,322
16,000	16,050	2,762	2,544	2,335
16,050	16,100	2,776	2,559	2,349
16,100	16,150	2,791	2,573	2,362
16,150	16,200	2,805	2,588	2,376
16,200	16,250	2,820	2,602	2,389
16,250	16,300	2,834	2,617	2,403
16,300	16,350	2,849	2,631	2,416
16,350	16,400	2,863	2,646	2,430
16,400	16,450	2,878	2,660	2,443
16,450	16,500	2,892	2,675	2,457
16,500	16,550	2,907	2,689	2,472
16,550	16,600	2,921	2,704	2,486
16,600	16,650	2,936	2,718	2,501
16,650	16,700	2,950	2,733	2,515
16,700	16,750	2,965	2,747	2,530
16,750	16,800	2,979	2,762	2,544
16,800	16,850	2,994	2,776	2,559
16,850	16,900	3,008	2,791	2,573
16,900	16,950	3,023	2,805	2,588
16,950	17,000	3,038	2,820	2,602
17,000	17,050	3,053	2,834	2,617
17,050	17,100	3,069	2,849	2,631
17,100	17,150	3,084	2,863	2,646
17,150	17,200	3,100	2,878	2,660
17,200	17,250	3,115	2,892	2,675
17,250	17,300	3,131	2,907	2,689
17,300	17,350	3,146	2,921	2,704
17,350	17,400	3,162	2,936	2,718
17,400	17,450	3,177	2,950	2,733
17,450	17,500	3,193	2,965	2,747
17,500	17,550	3,208	2,979	2,762
17,550	17,600	3,224	2,994	2,776
17,600	17,650	3,239	3,008	2,791
17,650	17,700	3,255	3,023	2,805
17,700	17,750	3,270	3,038	2,820
17,750	17,800	3,286	3,053	2,834
17,800	17,850	3,301	3,069	2,849
17,850	17,900	3,317	3,084	2,863
17,900	17,950	3,332	3,100	2,878
17,950	18,000	3,348	3,115	2,892
18,000	18,050	3,363	3,131	2,907
18,050	18,100	3,379	3,146	2,921
18,100	18,150	3,394	3,162	2,936
18,150	18,200	3,410	3,177	2,950
18,200	18,250	3,425	3,193	2,965
18,250	18,300	3,441	3,208	2,979
18,300	18,350	3,456	3,224	2,994
18,350	18,400	3,472	3,239	3,008
18,400	18,450	3,487	3,255	3,023
18,450	18,500	3,503	3,270	3,038
18,500	18,550	3,518	3,286	3,053
18,550	18,600	3,534	3,301	3,069
18,600	18,650	3,549	3,317	3,084
18,650	18,700	3,565	3,332	3,100
18,700	18,750	3,580	3,348	3,115
18,750	18,800	3,596	3,363	3,131
18,800	18,850	3,611	3,379	3,146
18,850	18,900	3,627	3,394	3,162
18,900	18,950	3,642	3,410	3,177
18,950	19,000	3,659	3,425	3,193
19,000	19,050	3,676	3,441	3,208
19,050	19,100	3,693	3,456	3,224
19,100	19,150	3,710	3,472	3,239
19,150	19,200	3,727	3,487	3,255
19,200	19,250	3,744	3,503	3,270
19,250	19,300	3,761	3,518	3,286
19,300	19,350	3,778	3,534	3,301
19,350	19,400	3,795	3,549	3,317
19,400	19,450	3,812	3,565	3,332
19,450	19,500	3,829	3,580	3,348
19,500	19,550	3,846	3,596	3,363
19,550	19,600	3,863	3,611	3,379
19,600	19,650	3,880	3,627	3,394
19,650	19,700	3,897	3,642	3,410
19,700	19,750	3,914	3,659	3,425
19,750	19,800	3,931	3,676	3,441
19,800	19,850	3,948	3,693	3,456
19,850	19,900	3,965	3,710	3,472
19,900	19,950	3,982	3,727	3,487
19,950	20,000	3,999	3,744	3,503

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11 · Borrowing and Banking

PERFORMANCE OBJECTIVES

After studying this chapter, you should be able to:

- Explain how borrowing works in principle, including the concept of amortization.
- Discuss the guidelines for using debt properly.
- Compute the effective cost of borrowing.
- Determine the dollar drain caused by borrowing, taking into consideration the effect of taxes and inflation.
- Describe the consumer protection offered by truth in lending.
- Explain how to shop for a loan.
- List and describe the advantages and disadvantages of the various sources of consumer loans.
- Describe the sources of education loans.
- Use the rule of 78 to calculate the rebate of finance charges on the prepaid balance of a loan.
- Describe the considerations involved in declaring bankruptcy.
- Describe how a checking system works.
- Describe how to balance a checkbook and avoid overdrafts.
- Explain the considerations in choosing a checking account and a bank.

OUTLINE OF THE MAIN IDEAS

I. Borrowing is the use of a lender's funds to expand your immediate purchasing power.
    A. The fee for the use of borrowed funds is the *finance charge*. It consists of two components.
        1. *Interest* is charged for the use of the money.
        2. There are also *carrying charges* for credit investigation and other costs.
        3. Finance charges may be added to the loan (add-on method) or subtracted from it (discount method). In the latter, the charges as a percentage of the loan will be higher.

B. Most installment loans are amortized.
1. This means that part of the principal is repaid with each installment so that the last payment ends the indebtedness.
2. This avoids having to pay the entire debt and charges at maturity, which might necessitate another debt.
C. There are certain obligations connected with debts.
1. Lenders look for assurance that loans will be repaid by demanding some security (*collateral*) behind the loan.
a. They may require that an asset be pledged, usually the one to be purchased with the borrowed funds (*chattel*).
b. They may require an *endorsement* or guarantee from a cosigner.
2. If there is no security, the loan is called an *unsecured loan*.
3. Lenders may charge a *prepayment penalty* because of charges lost while they reinvest. There will also usually be a *late penalty* of 5 percent of the delinquent amount.
D. The major advantage to borrowing is that you can acquire what you want without waiting; that is, pay for it while you are using it.
E. However, there are some disadvantages of borrowing.
1. It costs from 8 to 35 percent in finance charges.
2. It adds to the cost of the item purchased.
3. Instead of interest being paid to you for saving, you are paying interest to the lender.

II. You should use debt properly.
A. Borrow only to buy assets or durable goods (consumables should come out of your income).
B. Do not consolidate many small loans into one with a smaller amount but a longer time period.
C. Set debt limits.
1. Your need for borrowing (depending on your stage in the life cycle and income level) and the lender's idea of your ability to repay are two factors that will limit your debt.
2. If your ratio of debt to net worth (debt/equity ratio) is equal to or greater than 1, you should stop borrowing. Do not include your home or the mortgage on it in this computation.
3. No more than 20 percent of disposable income should be needed to pay debts (excluding home mortgage). But do not extend the loans to accomplish this.
4. Try to resolve all debts every three years.

III. You should know what effective costs of borrowing are.
A. The effective rate of interest on a loan may be double the stated rate.
B. The annual percentage rate of interest (APR) can be determined by the formula

$$\text{APR} = \frac{200\,Cn}{a(P + 1)}$$

C is the dollar cost of credit
n is the number of payments per year
a is the amount borrowed
P is the total number of payments
C. To determine the dollar drain of borrowing, you must calculate the dollar credit cost and the potential interest you would receive on the money invested elsewhere.
1. You should also consider the amount of reduced purchasing power of the dollars you borrowed due to inflation.
2. Since finance charges are tax deductible, you should consider your tax rate (see the text for equations).

IV. The Consumer Credit Protection Act of 1968 strives for truth in lending.
A. It requires that the terms of credit transactions be fully disclosed before the transaction is completed.
B. The repayment schedule must be set out in detail.
C. The collateral must be described.
D. Default, delinquency, and late payments must be disclosed.

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  - E. Your signature is considered proof of disclosure and that you understood what you were signing.
  - F. The total cost of credit must be expressed as an APR or an annual dollar amount.

- V. There are several steps in preparing to shop for a loan.
  - A. Decide the exact amount you need.
  - B. List why you need to borrow the money—shortage of funds, for example.
  - C. Note the purpose of the loan—to buy a car, for example.
  - D. Review your balance sheet and income statement.
  - E. List your present financial obligations, such as living expenses, debt payments, and dependents.
  - F. Review your employment record to be able to tell the lender about it.
  - G. Review your credit record to be able to relate past loans repaid and give your credit references.

- VI. There are also several things to consider when shopping for a loan.
  - A. Collect information from credit sources as to the exact amount you can borrow, finance charges, APR, repayment schedule, and collateral.
  - B. A lender will be looking for the 3 C's of credit: capacity or ability to repay, character or willingness to repay, and collateral in the event of failure to repay.
    - 1. A credit application form must usually be filled out.
    - 2. There will usually be an interview.
    - 3. There will usually be a credit investigation.
  - C. Beware of disreputable money lenders.

- VII. There are many sources of consumer loans (see Table 11-4).
  - A. From family and friends, the loan is private, there is a minimum of paperwork, and they might lend when the professionals won't.
  - B. Life insurance policies are also a source for loans.
    - 1. The maximum is your cash value.
    - 2. Borrowing reduces the amount payable to the beneficiary.
    - 3. The interest rate is likely to be low.
    - 4. Such loans are easily acquired.
  - C. Credit unions are another good loan source.
    - 1. They provide financial services only for their members.
    - 2. There are several advantages of borrowing from a credit union.
      - a. Interest rates are comparatively low.
      - b. For small loans, usually no security or endorsement is required.
      - c. Since the credit union consists of your associates, you can be confident of their integrity and sympathetic services.
      - d. Have programs to stimulate systematic savings, thus reducing your need to borrow in the first place.
  - D. Consumer finance companies are a source of small loans.
    - 1. The maximum loan is set by each state and ranges from $1,000 to $5,000.
    - 2. The maximum maturity is set by each state and ranges from 18 months to 5 years.
    - 3. They write loans in smaller amounts than most other lenders, but there are limits to the amount they may lend.
    - 4. Such loans are more easily qualified for than most other loans.
    - 5. Interest rates are usually higher than elsewhere.
    - 6. An advantage is that interest is usually computed on the outstanding balance, not on the initial amount.
  - E. Commercial banks are a fifth source of loans.
    - 1. They require you to have a better credit record, but interest charges are lower than for small loan companies.
    - 2. Unsecured installment loans, such as loans against a bank credit card and no-bounce loans, require only a signed promise to pay and are for shorter periods and higher rates than secured loans.
    - 3. Secured loans require collateral, such as the items purchased or the passbook of a savings account.

        4. There are several advantages to borrowing from commercial banks.
            a. Such institutions are very safe.
            b. Borrowing costs are comparatively low.
            c. It can result in a good credit rating for you.
        5. However, it is difficult to borrow small amounts, and qualification and payback requirements are rigid.
    F. Savings and loan associations mainly serve the home mortgage market.
    G. Pawnbrokers are commonly used only in emergencies or when the borrower's credit rating is not good. Their loans rarely exceed 50 to 60 percent of the appraised market value of the property, and interest rates are high.
    H. Second mortgages are another type of loan.
        1. The APR can be as high as 15 percent because of the 10 to 12 percent annual interest charge plus fees attached in the beginning of the loan.
        2. The monthly payments may be small, little more than interest payments, leaving a large balloon payment that may need to be refinanced.

VIII. There are two basic sources of education loans.
    A. Government
        1. The Basic Educational Opportunity Grant (GEOG) grants $200 to $1,800 for students from families with incomes to $26,000 depending upon the family's finances.
        2. The National Defense Education Act (NDEA) enables students at most colleges to borrow $1,000 to $5,000 per year.
        3. The Guaranteed Student Loan Program offers loans from private sources that are guaranteed by the U.S. government.
    B. Private sources such as churches, colleges, unions, etc.

IX. You should understand how prepayments on loans work.
    A. In the event you prepay a loan, you determine how much of the charge is rebated to you by using the *rule of 78*.
        1. Determine the inverse of the numerical notation for the payments yet to be made.
        2. Add the numbers in step 1.
        3. Divide this by 78 to get a percentage.
        4. Multiply the percentage times the original finance charge. The result is the amount of the rebate.
        5. Subtract the rebate of step 4 from the amount still due on the loan if all the remaining payments were made.
    B. You should consider prepayment penalties in your calculations.

X. Bankruptcy can be the result of using debt improperly.
    A. It may be indicated when your debts exceed your assets.
    B. You give up certain assets in return for being legally released from certain debts.
    C. Social Security and veterans' benefits are exempt from bankruptcy by federal law. Some states also exempt portions of the equity in a home, an economical car, and personal effects.
    D. Debts, such as alimony, unpaid income taxes form the last three years, child support, and debts incurred through fraud, cannot be discharged through bankruptcy.
    E. Declaration of bankruptcy entails three stages.
        1. Preparing and filing a petition
        2. Meeting creditors in the bankruptcy court to resolve their claims
        3. Having a court-appointed trustee collect and sell your assets and distribute the proceeds to your creditors
    F. To avoid bankruptcy, you may consider the wage-earner plan.
        1. With a counselor's help, you draw up a plan to resolve your debts over a specific period.
        2. If you can get the court and enough creditors to accept the plan, you begin making payments to the court, which will pay your creditors.
        3. During this period, interest and late payment penalties are generally waived.

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XI. Commercial banks offer three basic services: lending, saving, and checking. This section discusses checking.

- A. In a checking account, cash is rarely transferred from one bank to another. Check transactions are a series of bookkeeping entries in which the depositor's account is reduced and the payee's account increased. When banks of depositor and payee are in distant places, the Federal Reserve System assists in the check clearance process. See Table 11-5 in the text for a comparision of the various types of checking accounts.
- B. In choosing the bank for your checking account, consider
    1. Cost: what minimum balance is required, how the service charge is calculated, charges for no-bounce checks, stop payments, and the checks themselves.
    2. Convenience: if you need to visit the bank often, be sure it is close.
    3. Courtesy: for the times when you need personal attention.
- C. How to balance your checkbook:
    1. Enter the initial deposit in the balance column of your checkbook ledger or on the stub to the left of your next unused check.
    2. After each entry, compute the balance.
- D. To reconcile your book balance with the bank statement's balance:
    1. Sort the checks paid and returned by the bank in numerical or chronological order.
    2. Check the amounts of the checks against the checkbook and against the bank statement for accuracy.
    3. Check both checkbook and statement to be sure all deposits have been recorded.
    4. Check the arithmetic of the bank statement.
    5. Subtract checks still outstanding from your book balance.
    6. The result should bring both adjusted balances to the same amount.
- E. An overdraft occurs when you have insufficient funds to cover a check. The bank levies a charge for them, and they can impair your credit rating. Make sure you understand your bank's deposit policy, and keep your checkbook balanced.
- F. Safe-deposit boxes, money orders, and administration and management of trusts are other services banks offer.
- G. Automation in banking is becoming widespread.
    1. Salary and Social Security checks can be sent directly to your bank.
    2. The bank can automatically debit your account and credit the accounts of retail stores with computer terminals.
    3. However, the public is not yet convinced of the value of these developments.

SELF-TESTING EXERCISES

True-False

______ 1. Most installment loans are amortized.

______ 2. A good money manager will consolidate several smaller debts into one large one with a smaller installment payment over a longer time period.

______ 3. Borrowing should be restricted to the purchase of assets and durable goods.

______ 4. If your ratio of debt to net worth is equal to or greater than one, you should avoid any more borrowing.

______ 5. Consumer finance companies and credit unions are equally attractive as sources of loans.

______ 6. It is easier to get a loan from a commercial bank than it is to borrow on the cash value of your life insurance policy.

______ 7. When borrowing from a savings and loan association, there is no credit investigation.

_____ 8. You have no chance of a government grant for education if your family income is greater than $20,000.

_____ 9. If you are declared bankrupt, you are released from any and all debts outstanding.

_____ 10. If you have a no-bounce checking account, you have no worries about keeping a running balance or reconciling your check balance with the bank statement balance.

Completion

1. The part of the finance charge that is not interest is called the _____________ charge.
2. The process of reducing part of the principal with each installment payment is called _____________.
3. One who endorses a loan for another is called a _____________.
4. Excluding the home mortgage payment, no more than _____________ percent of disposable income should be used for paying debts.
5. In the formula $APR = 200Cn/a(P + 1)$, APR means _____________.
6. In the formula above, C represents _____________.
7. In the formula above, a represents _____________.
8. The three C's of credit are capacity, _____________, and collateral.
9. Since _____________ reduces the purchasing power of money, it reduces the dollar drain of credit.
10. To determine the amount of the finance charge that will be rebated in the event there is no penalty and you are repaying the loan early, the _____________ is usually used.

Multiple Choice

1. Commercial banks offer which of the following services?
   a. Loans
   b. Safe-deposit boxes
   c. Checking accounts
   d. Trust services
   e. (All of the above)

2. Which of the following is NOT a checking account plan?
   a. Minimum balance
   b. Maximum balance
   c. Activity plan
   d. Free checking

3. When preparing to shop for a loan, you should
   a. determine what you need
   b. establish your reasons for needing a loan
   c. update your balance sheet and income statement
   d. (All of the above)

4. It is best to borrow money to
   a. travel
   b. go to college
   c. buy clothes
   d. have a big night on the town

5. If you borrow $1,000 and make 12 $90 monthly payments to pay it back, what is the cost of the loan?
   a. $1,080
   b. $90
   c. $80
   d. $7

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6. Assume you borrow $500 for six months. Your payments are $90 a month. At the end of two months of payments your Aunt Mae offers to pay this loan off. How much is still owing, net of any finance charge rebates?

   a. $180.00
   b. $185.13
   c. $340.95
   d. $354.87
   e. $370.26

7. Your friendly lender offers to lend you $4,000 at a dollar credit cost of $1,000; you are to pay the loan off in a total of 18 monthly payments. What is the APR?

   a. 12%
   b. 19%
   c. 31.6%
   d. 315.9%

8. If your lender didn't give you the dollar credit cost, but instead supplied you with an APR of 18 percent, what would the dollar credit cost be on the same $4,000 loan paid back over 18 monthly payments?

   a. $540
   b. $570
   c. $750
   d. $900

9. Using the answer determined in Question 7, what is the effective rate of interest, assuming a 25 percent marginal tax rate and an annual rate of inflation of 5 percent?

   a. 18.7%
   b. 23.7%
   c. 31.7%
   d. 36.7%

Cases and Problems

1. John's disposable income is $1,200 a month. He has total debts of $4,500 and a net worth of $5,000.
   a. How much of his monthly income can John use safely for payments on his installment but not mortgage debt?
   b. According to his debt/equity ratio, how much more may he borrow before he is dangerously in debt?
2. Given the rate of interest charged in the exercise in Question 7 of the last section, what is your opinion as to the attractiveness of this loan offer? Does the effect of inflation and taxes on the cost of borrowing change your opinion? Should it?
3. Poor Bill ran short of money and borrowed $10 from his friend Jean. When he returned the $10 a month later, Jean asked Bill for a 15¢ stamp, which he gave her, saying, "Let's call it the interest on the loan."
   a. What is the annual interest rate on the loan?
   b. Given the range of interest rates charged by a small loan company, would this represent a low or high cost loan from such an organization?
   c. If the above one-month loan had been for $1,000 at 18 percent, how much would be paid in interest?
   d. What might be the reason a small loan company would charge this particular rate of interest?

PERSONAL MONEY MANAGEMENT ACTIVITIES

A. If you have an education loan, review its terms and contrast it with terms offered generally on other types of loans.

B. Determine what type of checking account you currently have. Visit your bank to find out whether another type of account might be more economical for you.

ADDITIONAL ACTIVITIES

A. Visit a local lender and ask how that institution evaluates prospective borrowers. Have the lender go over with you the various documents that comprise the loan agreement.

B. Ask a commercial banker how our check system works, both locally and nationwide.

RECORD ALL CHARGES OR CREDITS THAT AFFECT YOUR ACCOUNT

NUMBER	DATE	DESCRIPTION OF TRANSACTION	PAYMENT/DEBIT (−)		√ T	FEE (IF ANY) (−)	DEPOSIT/CREDIT (+)		BALANCE $	
			$			$	$			

REMEMBER TO RECORD AUTOMATIC PAYMENTS / DEPOSITS ON DATE AUTHORIZED.

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PACIFIC UNION
Bank & Trust Company
800 OAK GROVE, MENLO PARK, CA. 94025

DATE OF PREVIOUS STATEMENT	DATE OF THIS STATEMENT	
ACCOUNT NUMBER		
DISPOSITION CODE	NUMBER OF ENCLOSURES	PAGE NO

CHECKING ACCOUNT ACTIVITY (SEE REVERSE SIDE OF STATEMENT FOR IMPORTANT INFORMATION)

CHECKS AND OTHER DEBITS		DEPOSITS AND OTHER CREDITS		LOW BALANCE	AVERAGE BALANCE	SERVICE CHARGE	BEGINNING BALANCE
NO	AMOUNT	NO	AMOUNT				

TRANSACTION DESCRIPTION	AMOUNT	DATE	TRANSACTION DESCRIPTION	AMOUNT	DATE	RUNNING BALANCE	DATE
						ENDING BALANCE	

STATEMENT RECONCILIATION

STATEMENT BALANCE		$	
ADD-	DEPOSITS MADE BUT NOT SHOWN ON THIS STATEMENT		
	TOTAL	$	
SUBTRACT-	CHECKS OUTSTANDING		
TOTAL-	SHOULD AGREE WITH YOUR CHECK BOOK BALANCE	$	

CHECKS OUTSTANDING			
CHECK NUMBER		AMOUNT	
TOTAL-	ENTER IN THE SPACE PROVIDED ABOVE	$	

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12 · Borrowing: Consumer Credit

PERFORMANCE OBJECTIVES

After studying this chapter, you should be able to:

- Explain how consumer credit works in general, and how open-ended credit and installment credit work in particular.
- Use consumer credit appropriately.
- Describe the various forms of credit cards and charge accounts.
- Define (and describe the use of) sales contracts, notes, credit life insurance, oppressive clauses, and finance charges.
- Determine which credit arrangement, among several options, offers the best terms, given your needs and financial circumstances.
- Explain the importance of the Fair Credit Reporting Act, the Equal Credit Opportunity Act, the Fair Credit Billing Act, and legislation related to unauthorized use of credit cards.
- Explain the financial principles of auto leasing.

OUTLINE OF THE MAIN IDEAS

I. In consumer credit, the lender and seller are the same party. Consumer credit usually involves a *finance charge.*

II. There are two types of consumer credit.
   A. *Open-ended credit* involves charge accounts and credit cards.
      1. If you qualify for it, you agree to pay for the items within a certain number of days after you receive the bill.
      2. The costs to the credit issuer are generally passed on in increased prices.
      3. Issuers must disclose the time period that may elapse before finance charges will be levied on

the outstanding balance and the method used to compute the outstanding balance.

4. There are three ways of computing the outstanding balance.
    a. The most common, and in some states illegal, method is the *previous balance method* in which the charges are based on the balance outstanding at the end of the previous month. Payments made in the current month do not affect the computation.
    b. The *adjusted balance method* is that in which payments during the current month are deducted from the balance due, resulting in a lower finance charge.
    c. The *average daily balance method* is calculated by summing up the balances for each day of the current month and dividing by the number of days in the month. The earlier in the month payments are made, the lower this will be.
5. You should use open-ended credit properly.
    a. Pay the balance within the no-charge period if you can.
    b. Enter credit purchases in your budget when purchased. If you wait to be billed, you could exceed your budget.
    c. Be aware that the charges will be usually 18 percent annually.
6. Types of charge accounts and credit cards are shown in Table 12-1 of the text.
    a. *Thirty-day* accounts are those in which the debt is to be paid within 30 days without a finance charge.
    b. *Budget* charge accounts are those in which you must pay a specified amount within 30 days. The charge is usually 1.5 percent per month on the unpaid balance, which should be completely paid within 12 months.
    c. *Option* charge accounts are those in which you may pay all or part of the billed amount within 30 days at no charge and the remainder within three to six months. The same charge of 1.5 percent per month (18 percent annually) is levied on the unpaid balance. You may have to pay a fixed dollar minimum or a percentage of the amount outstanding each month.
    d. *Revolving* charge accounts are those in which you can continue to charge purchases up to a limit without first paying off the old debt. Both 30-day accounts and budget accounts can also be revolving accounts.
    e. *Bank credit card* accounts, such as Visa and MasterCharge, allow you to make purchases at numerous locations and receive one monthly statement that covers all purchases.
        (1) The retailers pay the bank a certain percentage of what they sell.
        (2) The bank assumes the costs of credit investigation, bill collection, and bad debts.
        (3) There is usually no finance charge if the payment is made within 25 days of the billing date.
        (4) Finance charges are usually 1.5 percent per month, up to $1,000; the percentage is then progressively reduced as the outstanding balance increases (to your credit limit).
        (5) Minimum payments of $10 or 5 percent of the balance are commonly required.
    f. National credit cards, such as Diners Club and American Express, are similar to bank credit cards, with some exceptions.
        (1) Credit qualifications are more rigid; therefore, maximum limits may be higher.
        (2) In addition to finance charges of 1.5 percent per month (18 percent per year) on the outstanding balance after 30 days, there may be an annual fee.
        (3)The cards may not be as widely accepted as the bank cards.

B. *Installment credit* also involves periodic payments.
1. It is normally used for purchases of higher priced consumer durables, such as appliances.
2. The items purchased serve as collateral.
3. There is a down payment and finance charges on the balance begin immediately.
4. The schedule of payments is rigid and there may be a prepayment penalty.
5. There is a purchase agreement that may include:
    a. The sales contract
        (1) It is designed to protect the creditor, and its contents are usually specified by state laws.
        (2) There are many types of sales contracts, but we discuss only the two most common types.
            (a) The *installment purchase agreement,* which is often used when you buy a new car on credit, gives you title and the use of the item, but the item is subject to a legally

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recorded lien. As a result, you may not use the item as collateral for another loan. If you default on your payment, the item may be repossessed and resold. You would receive only what was left after the debt and costs of repossession and resale were paid. If proceeds of the resale were insufficient to cover the debt and expenses, you would probably have to pay the difference.

(b) The *financing lease* is becoming more commonly used in car and furniture sales. Title and ownership do not pass to you until all lease rentals have been paid, at which time you may opt to buy the item for a nominal sum. Default under a financing lease is similar to that in (a) above.

(3) Oppressive clauses may be a part of either (a) or (b) above.

(a) The *wage assignment* clause gives the creditor the right to attach part of your wages if you default on payments.

(b) The *confession of judgment* clause causes you to waive your right to an attorney or to judicial processes, thus allowing your creditor to make an admission of debt for you if you should default.

(c) The *repossession* clause allows the creditor to take back the goods upon default.

(d) The *add-on* clause allows the creditor to take back items already paid for if you default on payments for other purchases.

(e) The *acceleration* clause causes the entire debt to become due immediately if you default on a single payment.

(f) The *balloon* clause structures the payments so that the final payment is much larger than the previous ones.

(4) Finance charges consist of interest and carrying charges; to check whether your annual percentage rate (APR) is as stated, use the constant ratio formula given in Chapter 11 of the text.

b. The note

(1) It specifies the amount you owe, the schedule and amounts of your payments, the procedures for default. It may also involve a security agreement.

(2) There are three general types of notes.

(a) The *demand* note gives the creditor the right to call in the note and receive full payment whenever he or she desires.

(b) The *time* note has a specified maturity date.

(c) The *cognovit* note (Latin: he or she knew) allows the creditor to repossess upon default without going through legal channels.

c. Credit life and disability insurance, up to the amount of the loan, may be required and may be part of the finance charge on installment purchases. It may be less expensive to buy this directly from an insurance company than through the creditor.

III. Credit counseling services

A. *Credit bureaus* provide information to creditors about their applicants and also often advise people seeking credit about their credit limits and how to retain or regain their good credit rating.

B. *Credit unions* sometimes employ credit counselors to educate their members about the wise use of credit.

C. *Family counseling* and *legal aid societies* are also available.

IV. Consumer credit legislation

A. One law is designed to protect you against unauthorized use of lost or stolen credit cards.

1. You may be liable for $50 worth of unauthorized purchases if the issuers provided you a self-addressed form to notify them of the credit card's loss, and if, when you accepted the card originally, the issuer informed you of your potential liability.

2. You should notify the issuer of the loss in writing, so you should keep the proper addresses on file.

B. Fair Credit Reporting Act

1. Credit bureaus sell information about credit applicants to grantors of credit.

2. Credit bureaus have three major information sources.

a. *Credit applications* should always be filled out carefully and accurately, since they become part of your credit record.

        b. *Public records,* such as court cases, judgments, and liens, may also be in your credit file.
        c. *Hearsay reports* from neighbors, friends, and acquaintances about your morals, private life, and reputation are subject to human error, bias, and poor judgment, but may be in your record also.
    3. If you are rejected for credit, the creditor must give you the name and address of the credit bureau that gave the information causing your rejection.
    4. If you request it, the credit bureau must then disclose:
        a. The information in your file
        b. The names of the creditors to whom it has issued reports on you in the last six months
        c. The names of potential employers who have received reports on you in the last two years
        d. The sources of the information in your file
    5. If the information is erroneous, unverifiable, or inaccurate, the credit bureau must delete it and notify creditors of the last six months and potential employers of the past two years. You may include with this notice a 100-word refutation of disputed information.
    6. If you have not been rejected but want to see your file, you may be charged a reasonable fee not in excess of $25.
C. The Equal Credit Opportunity Act prevents discrimination in lending on the basis of sex or marital status.
    1. A woman's credit application must be judged on the same basis as a man's. Alimony and child support payments must be considered as income.
    2. A lender may not ask the applicant's sex or marital status.
    3. An account must be carried in the name the applicant requests.
    4. No matter which spouse requests credit, the family credit history must be considered.
    5. A denial of credit must be explained.
D. The Fair Credit Billing Act also protects the consumer.
    1. It overturned the holder in due course doctrine. You may now refuse to make payments on faulty merchandise until your complaint is remedied.
    2. The creditor must acknowledge receipt of your complaint within 30 days and has an added 90 days to resolve the dispute.
    3. Bills must be mailed at least 14 days before payments are due.
    4. Retailers may now give a price discount (5 percent maximum) for cash payments.

V. If you lease an auto, basically you are paying a monthly fee for a set time period for the use of the car. At the end of the period, you return either the car or its cash value.
    A. In the beginning, you and the lessor negotiate the current value of the car and its projected trade-in value.
    B. The total amount of your lease payments (your loan) is determined by subtracting the trade-in (residual) value from the current value (purchase price). The lease payments include the finance charge.
    C. At the end of the lease, if the car's trade-in value is greater than expected, you get a refund; if the value is less, you pay the difference.
    D. Table 12-2 in the text shows that it is usually less of a dollar drain to pay cash for a car than either to finance it or lease it.

SELF-TESTING EXERCISES

True-False

_____ 1. The costs of extending credit through charge accounts generally increases the price of the merchandise.

_____ 2. The previous balance method of computing finance charges is more advantageous to the user of credit than is the adjusted balance method.

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______ 3. It is impossible to use charge accounts without incurring finance charges.

______ 4. Credit purchases should be entered in your budget immediately rather than waiting for the bill.

______ 5. There is usually an annual fee for the use of national credit cards.

______ 6. There may be oppressive clauses in an installment purchase agreement but not in a financing lease.

______ 7. With installment credit, you can be required to buy term life insurance.

______ 8. Family counseling services are a good source of credit advice.

______ 9. Credit bureaus use hearsay reports in the information they supply to creditors.

______ 10. If you are married, your credit accounts must be in the name of Mr. and Mrs.

Completion

1. There are two types of consumer credit: open-ended and ______________________.
2. When deductions of payments on the previous balance are made in computing the outstanding balance on which finance charges are based, the ______________________ balance method is being used.
3. A charge account in which the debt is to be paid in 30 days without a finance charge is called a ______________________ account.
4. Charge accounts that allow additional purchases before the old account is paid off are called ______________________ charge accounts.
5. Under the ______________________ in installment credit, you get title to and use of the item purchased.
6. The oppressive clause that allows a creditor to attach part of your wages if you default on your payments is called the ______________________ clause.
7. The ______________________ note allows the creditor to repossess the item purchased on credit upon default without using legal channels.
8. The oppressive clause that allows creditors to repossess items already paid for if you default on your payments is called the ______________________ clause.
9. A type of sales contract that is becoming more commonly used in car and furniture sales is the ______________________.
10. In installment credit, the schedule of payments is fixed and there may be ______________________ penalties.

Multiple Choice

1. The current value of a car to be leased is $6,000. Sales tax amounts to $300. The residual (trade-in) value at the end of three years is estimated to be $1,900. The amount to be financed by a lease is

   a. $6,360
   b. $6,000
   c. $4,400
   d. $4,100
   e. $3,150

2. The Fair Credit Billing Act did NOT
   - a. strike down the holder in due course doctrine
   - b. eliminate discrimination in lending
   - c. regulate billing methods
   - d. regulate the handling of billing complaints and errors
   - e. encourage retailers to give discounts to customers who pay cash

3. Which of the following is NOT a form of open-ended credit?
   - a. Revolving charge account
   - b. Bank credit card
   - c. Cognovit account
   - d. Budget charge account
   - e. National credit card

4. When shopping for credit, you should determine
   - a. what you want to use credit for
   - b. how much the use of credit will cost
   - c. whether you can afford to use credit
   - d. the reputation of the creditor
   - e. (All of the above)

5. Your maximum liability for the unauthorized use of your credit card under federal law is
   - a. $500
   - b. $100
   - c. $50
   - d. 0
   - e. no limit

6. Which oppressive clause gives the creditor the right to take a part of your regular paycheck if you miss a payment?
   - a. Confession of judgment
   - b. Repossession
   - c. Wage assignment
   - d. Balloon clause

7. The installment credit purchase agreement includes
   - a. a sales contract
   - b. a note
   - c. insurance policy provisions
   - d. (All of the above)

8. Which of the following methods of computing outstanding balance on open-ended credit is most advantageous for the consumer?
   - a Adjusted balance
   - b. Previous balance
   - c. Average daily balance
   - d. All are about the same.

Cases and Problems

1. You use your Visa card to buy a TV set from a local store. The set proves to be defective. What can you do about it?
2. Your application for credit at a local department store is rejected. What information must the department store give you and what recourse do you have?

PERSONAL MONEY MANAGEMENT ACTIVITIES

1. Ask a local bank for its credit application form. Fill out the form and ask the loan officer for his or her appraisal of you as a credit risk.
2. Look over your records of credit purchases for the past year. Determine how much you paid in finance charges and whether you could have avoided them.

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13 · Automobiles and Major Appliances

PERFORMANCE OBJECTIVES

After studying this chapter, you should be able to:

- Understand the needs and emotions behind the desire for long-lived consumer durables.
- Select the product that best meets your articulated needs.
- Shop for and negotiate the purchase of an automobile or other major appliance.
- Obtain the full useful life of the product purchased.

OUTLINE OF THE MAIN IDEAS

I. The purchase of autos and major appliances and their operating costs affect the budget substantially; therefore, the money manager should know how to buy, operate, and maintain these wisely.

II. The following buying principles apply to everything you buy.
   A. Know your needs and motivations before buying.
   B. Select the product that fits your needs.
   C. Shop around and time your purchases; negotiate price and terms with the seller.
   D. Control repair and operating costs once you own the product.

III. There are several things you should know when buying an automobile.
   A. Know your real needs for a car and be aware of how emotions can cause you to buy more than you need.
      1. Know the *total* costs of the car.
         a. Variable costs, such as for gas, oil, maintenance, and tires
         b. Fixed costs, such as for insurance, taxes, license, registration, and depreciation (which depends on age rather than use)
      2. Know the alternatives that may lower your transportation costs.

B. In selecting the car, there are some valuable points to consider.
  1. Ask the price of the same model from various dealers.
  2. Check its reliability, safety, etc. by consulting such surveys as reported in *Consumer Reports* or *Road and Track*.
  3. Find out whether any extra options may enhance the resale value of your car or whether they will be expensive to maintain.
  4. Find out how you can reduce operating and repair costs.
    a. Buy the smallest and least expensive car that meets your needs (see Table 13-2 in the text).
    b. Buy a used car.
    c. Keep a compact or subcompact for from 4 to 6 years or 60,000 to 80,000 miles, whichever comes first, after which repair costs exceed annual depreciation.
  5. The warranty on a new car should also be considered since it covers major cost items.

C. There are four things to know before and during the actual purchase of a car.
  1. The *dealer's cost* can be discovered from new car publications, such as *Edmond's* or *Charlton's*. Basic car costs are 15 to 24 percent below sticker prices, and basic options costs are about 25 percent below sticker prices.
  2. The *wholesale cost of your old car* can be found in *Kelley's Blue Book* or the *Official Used Car Guide*.
  3. The *dealer's markup* is the minimum margin over cost the dealer will accept; it is typically $300 to $500.
  4. The *competitive situation* can affect the price. That is, if there is a great demand for the car you want, you may have to pay the dealer's price, buy another type of car, or wait until the supply exceeds the demand.

D. Once you own the car, there are three aspects to controlling your operating costs.
  1. Get full value from your warranty. If the dealer can't or won't correct problems, arrange a meeting with the manufacturer's representative.
  2. Reduce repair and operating costs.
    a. Drive economically.
    b. Find through friends a reasonable and reliable service facility.
    c. Learn how to do it yourself and save labor costs of $10 to $30 per hour.
  3. Minimize depreciation costs by taking proper care of the car.

IV. There are four steps to follow when buying major home appliances.
  A. Know your needs for an appliance.
    1. Set priorities for which appliances should be acquired first.
    2. Estimate the real costs of the appliance—the operating cost, depreciation, and opportunity cost (the interest you could have earned on the money used to buy it).
  B. Select the appliance that fits your needs.
    1. Since it has a long, useful life, buy one of good quality.
    2. Check consumer publications for best buys.
    3. Evaluate the financial importance of certain criteria for various appliances (see Table 13-3).
    4. Check the warranty and location of service centers.
  C. Make the purchase itself.
    1. Shop around.
    2. Take advantage of sales that occur at periodic times, such as television sales in July and August.
  D. Maintain the product for its useful life with a minimum of service calls.
    1. Follow the instructions in the service manual.
    2. Before calling for service, see if there is a simple solution.
    3. It is usually better to pay for repairs when needed than to sign a service contract.
    4. If you want to dispose of an appliance, want ads usually give better results than trade-ins.

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SELF-TESTING EXERCISES

True-False

_____ 1. Proper timing of purchases means that some times or months are better than others for purchases of specific items.

_____ 2. Most people are not emotionally motivated when they purchase major items.

_____ 3. The cost of a license and registration fee is a variable cost of owning a car.

_____ 4. The cost of insurance is a fixed cost of owning a car.

_____ 5. Since warranties on new cars are not offered for profit, it pays to buy a car with a warranty, other things being equal.

_____ 6. The wholesale cost of your old car can be found in *Edmond's* or *Charlton's* publications.

_____ 7. The minimum margin over cost that dealers will accept is typically $300 to $500.

_____ 8. It is less expensive to buy a service contract than to pay for appliance repairs when needed.

Completion

1. A ____________________ size car can cost from $30 to $60 per month more in total cost than a subcompact car.
2. The wholesale cost of your old car can be found in ____________________ or the *Official Used Car Guide*.
3. ____________________ get about 100 miles per gallon.
4. Basic car costs are 15 to 24 percent below ____________________ prices.
5. If a dealer can't or won't correct problems under a warranty, you should arrange a meeting with a ____________________.

Multiple Choice

1. Costs of gas and oil are best described as

   a. fixed
   b. indirect
   c. variable
   d. maintenance
   e. (All of the above)

2. Depreciation on your car represents which kind of costs?

   a. Fixed
   b. Indirect
   c. Variable
   d. Maintenance
   e. (None of the above)

3. Which of these may lower your transportation costs?

   a. Using mass transit
   b. Buying a used car
   c. Riding in a carpool
   d. Living close to work
   e. (All of the above)

4. Basic car costs are what percent below sticker prices?
   - a. 5 to 14
   - b. 10 to 19
   - c. 15 to 24
   - d. 20 to 29
   - e. 25 to 34

5. The best source of information on reliability, safety, gas mileage, and best buys for new cars is
   - a. *Kelley's Blue Book*
   - b. *Official Used Car Guide*
   - c. *Edmond's*
   - d. *Road and Track*
   - e. (All of the above)

Cases and Problems

1. Kevin's transportation costs are 20 percent of his total expenses. He is 21 years old, single, has a fairly good salary and a hot car to match. He lives about 25 miles from his job. Should Kevin try to reduce his transportation costs and if so, how?

2. Jane feels she needs a new car. She has fallen in love with one with a sticker price of $5,000. Her boyfriend informs her that the dealer will accept a minimum of $400 as his markup on cost. She looked in *Edmond's New Car Prices* and found that the cost to the dealer was $4,200. Her old car has a *Kelley's Blue Book* price of $1,200 and the salesperson has offered her a trade-in of $750 on her old car. As a financial advisor, what would be your advice to Jane?

3. Tom and Mary, who plan to marry, have about $1,500 in savings between them. Both are employed but because Tom's firm moves management trainees frequently, they have decided to rent. They feel they will receive cash and appliances as wedding presents but are planning now to buy items they feel might reduce their rent, such as furniture. Advise Tom and Mary how to proceed in providing their apartment with the things they need.

PERSONAL MONEY MANAGEMENT ACTIVITIES

1. Check the costs of service agreements on the same year and model TV sets sold by local TV outlets. Do the costs remain the same each year? If not, how much do they differ each year at each outlet? Would buying any of the agreements be advantageous?

2. After settling on a given model and options on a new car and determining the wholesale value of your old car, check with two or three dealers to determine the spread in prices and trade-in values.

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14 · Housing

PERFORMANCE OBJECTIVES

After studying this chapter, you should be able to:

- Compare the advantages and disadvantages of renting with those of buying, particularly in regard to costs.
- Describe the factors involved in determining your housing needs and your price range.
- Explain the legal considerations involved in renting, with particular emphasis on tenant-landlord relations.
- Describe the most effective way to go about purchasing a home, including arranging for financing.
- Describe many of the considerations in building a home.
- Describe what must be taken into consideration when selling a house.
- Explain the advantages and disadvantages of owning a mobile home, cooperative apartment, or condominium rather than a house.
- Outline the major considerations when buying a vacation home.

OUTLINE OF THE MAIN IDEAS

I. Your housing alternatives are either to rent or to own. The choice depends on your personal situation and values.

II. The advantages of renting are many.
   A. It involves no major outlay of capital.
   B. It offers greater mobility and flexibility.
   C. It reduces chores of repairs, mowing, weeding, and the like.
   D. It often includes amenities such as pools and saunas.

III. There are also disadvantages in renting.
A. The entire rent payment is an expense and is not tax deductible; you are building no asset value.
B. There is no protection against rent increases (except for the term of the lease).
C. There is less privacy.

IV. There are many advantages to owning a home.
A. There is a feeling of permanence, security, and satisfaction.
B. Your loan payments are constant (unless you have a variable rate mortgage).
C. Your mortgage payments, which reduce your principal, are a form of forced savings.
D. Over the long run, owning is often less expensive than renting.

V. Some of the disadvantages of owning a home are given below.
A. It usually requires a major capital outlay.
B. It may be more expensive than renting if owned only for a short time.
C. You sacrifice mobility and flexibility.

VI. You should compare the costs of renting versus owning a home.
A. Rent payments include the landlord's costs of property taxes, maintenance, obsolescence, mortgage payment, return on investment, plus a vacancy allowance and management costs.
B. The homeowner incurs all these costs except the last two, plus the costs of selling the home (which decreases the longer the home is owned).
C. Renting can be more costly because of inflationary rent increases.
D. Although inflation increases the value of your present home, your next home will also have an inflated price.
E. Speculation has reinforced inflation, causing home prices in some areas to double in 10 years (see Table 14-2 in the text).

VII. Here are some points to consider when choosing a residence.
A. Research the location.
1. A real estate maxim holds that location is the most important consideration. It is usually better to buy a less expensive house in a good neighborhood than an expensive house in a lesser neighborhood.
2. The choice of rural, urban, or suburban depends upon your work and lifestyle.
3. You should research the costs of living in each desired location.
4. You should also research future plans of highway departments and zoning laws to be sure there will be no future changes in the location you have chosen.
B. Research the apartment or house itself.
1. What are your needs?
2. Should it be an older or a newly built residence?
a. Some of the advantages of an older residence are that you can choose a larger one for the same cost as a smaller new one; the older home may have more landscaping and interior decorating; it may be more unique and have more character.
b. Some of the disadvantages of an older residence are that it is usually located in the older section of the town or city and may be more difficult to sell and finance.
C. Research the costs of renting and of buying.
1. In renting, a rough guide is that you can afford 25 percent of your after-tax income (about one week's salary) in rent per month.
2. In buying, the price of the home, as a rule of thumb, should not exceed two and one-half times your annual after-tax income. Annual recurring costs are about 10 percent of the value of the house. If your annual after-tax income is $20,000, you can (theoretically) afford a $50,000 house and the annual recurring costs of $5,000. Determine what you can afford by analyzing the various costs.
a. One-time costs include the down payment, the closing costs or fees for credit reports, FHA (Federal Housing Administration) insurance commitment, a loan origination fee, escrow costs, title insurance, a termite inspection, legal fees, and recording fees. Local custom decides whether the buyer or seller pays these closing costs or fees. Your balance sheet informs you if you can afford these costs. You may want to make your down pay-

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ment as large as possible, since you will then need a smaller loan at perhaps a lesser interest rate, or, depending on your investment strategies, you may wish to keep the down payment small.

b. Annual recurring costs are principal, interest, taxes, insurance, utilities, and maintenance.

D. Compare your present housing costs with the above costs to see if you can afford to buy now.

VIII. Renting

A. Alternatives

1. Rental units are usually either single-family houses or multifamily apartments.

2. The Housing and Urban Development Act provides below-market rentals for the economically disadvantaged.

3. Rent supplements from the federal government are available for those whose income is below limits set by the FHA office for the community, for those displaced from their homes by government action or natural disaster, for the handicapped, for those over 62, or for those now in substandard housing.

B. The rental or lease agreement

1. A rental agreement is usually on a month-to-month basis while a lease is for longer time periods.

2. There is no standard rental or lease agreement, and most of them are designed to protect the landlord, not the renter.

3. You should understand the terms used in the rental or lease agreement.

a. *Rent* is usually paid monthly. The first two months' and the last month's rent may be required in advance to protect the landlord if you move before the agreement expires. There may also be a 5 percent penalty for late rent payments.

b. A *deposit* in addition to the last month's payment may be required to repair or refurbish, if necessary.

c. The *term* of a *lease* may be from one to five years, and payments are usually fixed during that period.

d. The agreement should specify who pays *expenses*, such as utilities and repairs.

e. Be sure you understand the *restrictions* in the agreement, such as children, pets, subleasing, and the like.

C. Tenant-landlord relations

1. Traditionally, the law has favored the landlord, allowing him or her to evict the nonpaying tenant merely by proving ownership, a lease, and tenant's failure to pay rent.

2. Recently, courts have improved the legal position of tenants.

a. When rental units do not conform to building and housing codes, tenants may generally void their lease and move, make their own repairs and deduct costs from the rent, or pay a reduced rent.

b. Evictions in retaliation for a tenant's action in pressing for repairs have been held to be violations of free speech.

c. Landlords at times have been denied the right to seize and sell the personal possessions of nonpaying tenants.

d. In at least 16 states, legislatures have passed the Uniform Residential Tenant and Landlord Act.

IX. Buying a house

A. Choose an experienced broker.

1. Tell the broker what you want and can afford and the location you desire.

2. The broker will search for your home for 10 to 14 days or as long as he or she is sure you really intend to buy.

B. Evaluate the condition of the lot and the house.

1. Check the lot for size and adequacy, access, sewage, noise, drainage, and the like.

2. For new homes, you may buy a homeowner's warranty that protects against malfunctioning of plumbing, heating, and electrical systems for the first two years and against structural defects for 10 years. The cost is between $2 and $3 per $1,000 of the selling price of the house.

3. If a warranty is not offered, hire an impartial builder, architect, or home appraiser to inspect the house. The cost is from $50 to $100 (see Figure 14-1 in the text).
4. Have a termite inspection made by a reputable termite control firm recommended by local lenders and realtors.

C. Negotiating the price
1. Sellers often set their asking price about 10 percent above what they will sell for, expecting to be haggled down.
2. Your counteroffer and terms, generally stated in the purchase contract, might be 15 to 20 percent below the asking price.
3. The seller usually counters your offer again and sends the contract back for your acceptance or further negotiations.
4. To make the negotiating process successful, follow the steps given below.
   a. Determine whether you are in a buyer's or seller's market and the seller's particular situation (such as job change, death, or divorce).
   b. Set limits in advance as to price, down payment, finance terms, etc., and stick to them.
   c. Be sure your offer is reasonable by checking recent selling prices for similar homes in the area. You can get this information from realtors and lenders.
   d. Know the aspects on which you can compromise so that you can be flexible where you can afford to be.
   e. Resist the temptation to compromise unduly. Keep in mind that there are other homes available.
   f. Remember that the seller is probably as anxious to sell as you are to buy.

D. The deposit
1. This is evidence of your intention to buy; it may be applied to the down payment, or forfeited if you fail to buy.
2. The deposit is sent to the escrow agent, who holds it until the purchase agreement is completed.

E. The purchase contract
1. This is a legal contract signed by both buyer and seller; you can cancel it only if its terms are not met. Be sure you are satisfied with all its clauses and consult an attorney before you sign it.
2. You can include clauses of your own such as prohibition against raising the purchase price, minimum acceptable financing, closing date, disclosure of easements, and so forth.

F. Deed and title
1. The deed is a legal document used to convey title to property from the grantor (owner) to the grantee.
2. The title is the ownership interest and needs protection against restrictions that may have been put upon it. There are three types of title protection.
   a. A *title abstract* is a history of the ownership of the property.
   b. A *certificate of title* is an attorney's opinion on the condition of the title.
   c. *Title insurance* protects you against loss if a flaw in the title is discovered.
3. There are several types of deeds.
   a. The *warranty* deed is the safest because it guarantees that the title is free of restrictions.
   b. The *special warranty* deed guarantees only that the grantor has not placed any encumbrances on the property.
   c. The *quitclaim* deed merely extinguishes the grantor's title.
   d. The deed of *bargain and sale* lacks the coverage of a warranty deed but asserts that the grantor has an ownership interest on the property transferred.

G. The down payment is the initial cash you put up to buy the property. Closing costs, moving expenses, new furniture, etc. may make a lower down payment advisable, especially since the interest rates on mortgages are generally much lower than rates on installment loans.

H. The mortgage
1. It is the security afforded the lender in which title to the property is conveyed to the lender. In the event of payment defaults, the lender may repossess the house.
2. Mortgage interest rates vary with economic conditions.

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3. Mortgages are generally amortized, as discussed in Chapter 11.
4. There are at least two variations of the standard mortgage.
   a. The *variable rate mortgage* (VRM) is one in which interest rate changes with economic conditions. The change is keyed to rates such as the prime mortgage rate and is adjusted every six months to a year. There are three basic types of VRMs.
      (1) The *straight* VRM links changes to an independent index.
      (2) The *roll-over* VRM sets the rate for a period of years after which it is renegotiated or converted to a straight VRM.
      (3) The *escalator* VRM gives lenders the option to change the rate when they think it is warranted.
   b. In a *flexible payment plan* the payments are geared to the borrower's situation. For younger people, early payments may be low in the early years, increasing later as ability to pay increases.
5. Mortgages can be insured by public or private sources.
6. Early low payments and low down payments result in higher interest costs.
7. Repayment period
   a. It is usually from 10 to 30 years.
   b. The longer the period, the smaller your payments will be but the total interest will be larger.
   c. Some people prefer the smaller payments and long maturities because they feel it is a type of forced savings. Also, they feel they can invest the amounts saved at higher rates than the mortgage rate.
8. Obtaining a mortgage
   a. There are three types of mortgage loans.
      (1) The *conventional* mortgage is solely between you and the lender. It is amortized, uses the fixed payment mortgage and matures in 25 or more years. The loan is from 60 to 90 percent of the appraised value of the home and therefore requires a sizable down payment.
      (2) The *FHA* (Federal Housing Administration) mortgage offers insurance on mortgage and other loans. Table 14-6 in the text provides three examples of FHA insurable loans and conditions under which they will be insured. Usually, with FHA insurance lenders do not require as large a down payment as with a conventional loan.
      (3) The *VA* (Veterans Administration) *loan guarantee* guarantees (but does not make loans) against loss to lenders, appraises the property and guarantees up to 60 percent of the appraised value of the home to a maximum of $25,000. To be eligible, the interest must not exceed a specified rate, and the buyer must have had at least 90 days of active duty in World War II, the Korean War, or the Vietnam War. It is available more than once if the previously guaranteed loan has been paid off and the property has been disposed of. It presently includes mobile homes.
9. Points
   a. This is a method of determining the fee charged as a lump sum at the start of a loan to compensate the lender for the loss of yield on his loan when government interest rates on FHA and VA mortgages are lower than the rates on conventional loans.
   b. One point equals 1 percent of the amount borrowed.
   c. Generally, two points are charged for each quarter of 1 percent difference between the rate on conventional loans and the ceiling rate on FHA- and VA-backed loans.
   d. A *front-end load* or *loan origination fee* may be charged on either conventional or government-backed loans; it is also expressed in points ranging from one to two points.
10. Second mortgages
    a. These are necessary when down payments are small and the original lender is unwilling to lend the full balance.
    b. Their rates are higher since they have only the residual security of the first mortgage holder and are therefore riskier.
    c. Since inflation has increased the owner's equity in many homes, banks are actively soliciting borrowers in this area.
    d. Rates range from 12 to 18 percent, with maturities generally from 5 to 10 years.

    11. Sources of mortgage loans
        a. Savings and loan associations
        b. Credit unions
        c. The seller
        d. Assumption of the existing mortgage

X. Building a home
    A. Are you qualified to do it, and do you have the time?
    B. The same rules about location in buying apply to building, but zoning and building restrictions are more important. In addition, you will probably have to pay cash for your lot.
    C. Ask advice about architects and check them for
        1. Creative imagination
        2. Knowledge of nuts and bolts
        3. Their understanding of what you want
    D. An alternative is to use a stock plan instead of an architect.
    E. Can you perform the functions of a general contractor in supervising subcontractors and know when to do what?
    F. You will need interim financing until the home is built.
    G. Can you do the construction yourself or do you know how to get the qualified people?

XI. Selling your home
    A. Can you do it yourself or should you pay the 5 or 6 percent commission to use a professional?
    B. Determine price, financing, other costs you will incur, and other details.

XII. Other alternatives
    A. Mobile homes
        1. They suit the needs of certain groups.
        2. They are similar to apartment living.
        3. They cost less than traditional homes, both to buy and to maintain, but do not offer as much inflationary hedge as traditional homes.
        4. In selecting a mobile home, your first consideration should be where you will "park" it. Consult Woodalls' rating scheme for ranked quality of mobile home parks.
    B. Cooperative apartments
        1. You buy a share of ownership proportionate to the space you are using of the entire complex.
        2. You are subject to monthly charges that cover maintenance, debt retirement and interest, taxes, insurance, and an emergency fund.
    C. Condominiums
        1. You buy your unit outright. The price includes an interest in common areas.
        2. It costs less than a separate home and yard.
        3. Monthly fees are assessed for taxes, maintenance, etc.
        4. In shopping for a unit, beware of underestimates of the costs and arbitrary increases in fees for facilities by developers who retain control over these areas.
    D. A second home in the country
        1. Buy from an individual rather than a developer.
        2. Visit the property and compare prices on similar lots.
        3. Check water, sewage, and other utilities.
        4. Check building costs and taxes.

SELF-TESTING EXERCISES

True-False

_____ 1. Over the long run, owning your home is less expensive than renting.

_____ 2. It is better to buy a less expensive house in a good neighborhood than an expensive home in a lesser neighborhood.

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____ 3. Older homes are easier to sell and finance than newer ones.

____ 4. Most rental or lease agreements are designed to protect the tenant.

____ 5. When interest rates on conventional mortgages are higher than the rates on government-backed mortgages, the seller charges points.

____ 6. Interest rates on second mortgages are lower than on first mortgages.

____ 7. A title abstract is the attorney's opinion on the condition of the title to the property.

____ 8. If interest rates on installment credit are higher than the interest rates on mortgages and you need to refurnish your home, a low down payment is indicated.

____ 9. VA-guaranteed mortgage loans may be made on mobile homes.

Completion

1. Rent payment should be roughly ________________ percent of after-tax income.
2. The price of a home, as a rule of thumb, is ________________ times your annual after-tax income.
3. A legal document used to convey title to property from grantor to grantee is called a ________________.
4. A history of the ownership of a property is called a ________________.
5. A mortgage in which the interest rate changes with economic conditions is called a ________________.
6. Mortgage plans that are geared to the borrower's situation are called ________________ plans.
7. A government-backed insurance on a loan is available from the ________________.
8. A government-backed loan guarantee for a certain type of citizen is called a ________________ loan guarantee.
9. One point equals ________________ percent of the amount borrowed.
10. For each quarter of 1 percent difference in interest rates between conventional loans and government-backed loans, the lender charges ________________ points.

Multiple Choice

1. You obtain an 8 percent mortgage for 25 years in the amount of $24,000. Your monthly payment is approximately $183. What is the total interest cost of this mortgage?

   a. $ 4,575
   b. $24,000
   c. $30,900
   d. $54,900

2. The mortgage is the

   a. interest rate on the loan made to purchase a house
   b. security offered by a borrower to a lender to obtain the loan necessary to buy a house
   c. periodic payment on a loan made to purchase a house
   d. (All of the above)

3. Which of the following is NOT an annually recurring expense of owning a house?

   a. Property taxes
   b. Title insurance
   c. Loan repayments
   d. Home insurance

4. When buying a house, you may want to make the down payment as large as possible because
   - a. the more cash you put down initially the smaller the loan you will need
   - b. you minimize total interest costs on the loan
   - c. you may preclude the need for a second mortgage
   - d. (All of the above)

5. An offer should be made on a house only after you have
   - a. checked with the neighbors to see what they paid for their houses
   - b. decided that this is the only house you want at any price
   - c. checked to see if a similar house in a similar location is being sold or has sold recently and, if so, for how much
   - d. managed to obtain a loan to buy the house

6. Which of the following is an alternative form of home ownership?
   - a. Condominium
   - b. Cooperative apartment
   - c. Mobile home
   - d. (All of the above)

7. Which of the following are the basic cost elements of buying a house?
   - a. Down payment
   - b. Mortgage
   - c. Closing costs
   - d. (All of the above)

8. Which of the following is typically characteristic of an older house?
   - a. Easier to resell
   - b. Usually located farther from central cities
   - d. Title is easier to clear
   - c. More square feet for the same price

9. Which of the following costs is NOT related to owning your home?
   - a. Property taxes
   - b. Maintenance
   - c. Mortgage interest
   - d. Management fee

Cases and Problems

1. You have negotiated a price of $50,000 with the seller to buy his house. You can afford a $15,000 down payment, but the lender with the most attractive mortgage terms will lend only $30,000 on this house. What are your alternatives?
2. You finally agree to obtain a second mortgage of $5,000 from your rich uncle. It happens that your uncle is a real estate lender and charges you four points in loan origination fees, although the first mortgage lender charged only two points. On top of all this, you have to pay title insurance fees of $230, escrow fees of $130, and attorney's fees of $250. What are your total front-end costs?
3. The terms of your rich uncle's second mortgage are a maturity of five years and $1,000 of principal to be repaid each year with interest at 10 percent. During this period, your mutual fund investment of $5,000 appreciates 10 percent a year. This particular fund pays no dividends. At the end of each year, you liquidate enough shares to make your second mortgage loan payment ($1,000 plus year's interest due). Your tax bracket is 25 percent. How much better was it to borrow from your rich uncle than liquidate your mutual fund in the beginning to provide the unfunded portion of the purchase price? What was the risk of this strategy?

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PERSONAL MONEY MANAGEMENT ACTIVITIES

1. If you are a renter, reread your rental agreement and answer these questions.
   a. How much is the penalty for a late payment?
   b. What restrictions does the agreement contain?
   c. Under what conditions will your deposit be returned?
2. If you own your own home, answer these questions.
   a. Why did you choose its present location?
   b. Did you make a large or small down payment?
   c. What mistakes did you make and how can you correct these next time?

ADDITIONAL ACTIVITIES

1. Visit a local real estate office and have a broker describe the current market for home purchases or rental units. Ask how the agent helps a client determine what is appropriate.
2. Visit a local legal assistance office. Ask a representative what efforts are made in behalf of tenants in their relations with landlords.

Lease

National Housing and Economic Development Law Project Standard Form Lease (California)

1. *Parties*

The parties to this agreement are ______________________________

____

____

______________________________, hereinafter called "Landlord,"

and ______________________________

____

____

______________________________, hereinafter called "Tenant."

If Landlord is the agent of the owner of said property, the owner's name and address is ______________________________

____

2. *Property*

Landlord hereby lets the following property to Tenant for the term of this agreement: (a) the property located at ______

____

and (b) the following furniture and appliances on said property: ______________________________

____

____

3. *Term*

The term of this agreement shall be for ______________, beginning on ______________________ and ending on

____

4. *Rent*

The monthly rental for said property shall be $________, due and payable on the first day of each month.

5. *Utilities*

Utilities shall be paid by the party indicated on the following chart:

	Landlord	*Tenant*
Electricity		
Gas		
Water		
Garbage collection		
Trash removal		
Other		

6. *Use of Property*

Tenant shall use the property only for residential purposes, except for incidental use in his trade or business (such as telephone solicitation of sales orders or arts and craft created for profit), so long as such incidental use does not violate local zoning laws or affect Landlord's ability to obtain fire or liability insurance.

7. *Tenant's Duty to Maintain Premises*

Tenant shall keep the dwelling unit in a clean and sanitary condition and shall otherwise comply with all state and local laws requiring tenants to maintain rented premises. If damage to the dwelling unit (other than normal wear and tear) is caused by acts or neglect of Tenant or others occupying the premises with his permission, Tenant may repair such damage at his own expense. Upon Tenant's failure to make such repairs, after reasonable notice by Landlord, Landlord may cause such repairs to be made and Tenant shall be liable to Landlord for any reasonable expense thereby incurred by Landlord.

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8. Alterations

No substantial alteration, addition, or improvement shall be made by Tenant in or to the dwelling unit without the prior consent of Landlord in writing. Such consent shall not be unreasonably withheld, but may be conditioned upon tenant's agreeing to restore the dwelling unit to its prior condition upon moving out.

9. Noise

Tenant agrees not to allow on his premises any excessive noise or other activity which disturbs the peace and quiet of other tenants in the building. Landlord agrees to prevent other tenants and other persons in the building or common areas from similarly disturbing Tenant's peace and quiet.

10. Inspection by Landlord

Landlord or his agent may enter the dwelling unit only for the following purposes: to inspect to see if Tenant is complying with this Agreement, to make repairs, and to exhibit the unit to prospective purchasers, mortgagees, and tenants. Such entries shall not be so frequent as to seriously disturb Tenant's peaceful enjoyment of the premises. Such entries shall take place only with the consent of Tenant, which consent shall not be unreasonably withheld. If, however, Landlord or his agent reasonably believes that an emergency (such as a fire) exists which requires an immediate entry, such entry may be made without Tenant's consent. If such emergency entry occurs, Landlord shall, within two days thereafter, notify Tenant in writing of the date, time, and purpose of such entry.

11. Security Deposit

a) Tenant shall pay Landlord, upon execution of this agreement, a security deposit of $________. Said deposit may be applied by Landlord toward reimbursement for any cost incurred because of Tenant's violation of this Agreement, including nonpayment of rent.

b) Landlord shall place this security deposit in a bank savings account or savings and loan institution account bearing the prevailing rate of interest and shall credit such interest to the security deposit. Within 14 days of the date of this Agreement, Landlord shall notify tenant in writing of the location of such account and the account number.

c) Landlord shall inspect the premises within one week prior to termination of this Agreement and, before Tenant vacates, shall give Tenant a written statement of needed repairs and the estimated cost thereof.

d) Within two weeks after Tenant vacates the premises, Landlord shall return to Tenant his security deposit, with accrued interest, less any deductions Landlord is entitled to make under subparagraph (a) of this Paragraph and Paragraph 17. If any deductions are made, Landlord shall also give Tenant a written itemized statement of such deductions and explanations thereof. No deductions shall be made, however, for any repairs not listed in the statement required by subparagraph (c).

12. Landlord's Obligation to Repair and Maintain Premises

a) Landlord shall maintain the building and grounds appurtenant to the dwelling unit in a decent, safe, and sanitary condition, and shall comply with all state and local laws, regulations, and ordinances concerning the condition of dwelling units.

b) Landlord shall take reasonable measures to maintain security on the premises and the building and grounds appurtenant thereto to protect tenant and other occupants and guests of the premises from burglary, robbery, and other crimes. Tenant agrees to use reasonable care in utilizing such security measures.

c) As repairs are now needed to comply with this paragraph, Landlord specifically agrees to complete the following repairs by the following dates:

Repair	*Date*

d) If Landlord substantially fails to comply with any duty imposed by this paragraph, Tenant's duty to pay rent shall abate until such failure is remedied. This subparagraph shall apply to defects within Tenant's dwelling unit only if Tenant has notified Landlord or his agent of such defects and has given Landlord a reasonable time to make repairs. The remedy provided by this subparagraph shall not be exclusive of any other remedy provided by law to Tenant for Landlord's violation of this Agreement.

13. Subleasing

Tenant shall not assign this Agreement or sublet the dwelling unit without the written consent of Landlord. Such consent shall not be withheld without good reason relating to the prospective tenant's ability to comply with the provisions of this Agreement. This paragraph shall not prevent tenant from accomodating guests for reasonable periods.

14. Failure to Pay Rent

If Tenant is unable to pay rent when due, but on or before such due date he gives Landlord or his agent written notice that he is unable to pay said rent on time and the reasons therefore, Landlord shall attempt to work out with Tenant a procedure for paying such rent as soon as possible. If, after 10 days, Landlord and Tenant are unable to work out such a procedure, Landlord may serve a notice to pay rent or vacate within 3 days, as provided by California Code of Civil Procedure Section 1161.

15. Destruction of Premises

If the premises become partially or totally destroyed during the term of this Agreement, either party may thereupon terminate this Agreement upon reasonable notice.

16. Tenant's Termination for Good Cause

Upon 30 days written notice, for good cause, Tenant may terminate this Agreement and vacate the premises. Said notice shall state good cause for termination. Good cause shall include, but not be limited to, entry into active duty with U.S. military services, employment in another community, and loss of the main source of income used to pay the rent.

17. Termination

Upon termination of this Agreement, Tenant shall vacate the premises, remove all personal property belonging to him, and leave the premises as clean as he found them (normal wear and tear excepted).

18. Lawsuits

If either party commences a lawsuit against the other to enforce any provision of this Agreement, the successful party shall be awarded court costs from the other. Landlord specifically waives any right to recover treble or other punitive damages pursuant to California Code of Civil Procedure Section 1174.

19. Notices

All notices and rent provided by this Agreement shall be in writing and shall be given to the other party as follows:

To the Tenant: at the premises.

To the Landlord: at ______________________________

20. Holdovers

If Tenant holds over upon termination of this Agreement and Landlord accepts Tenant's tender of the monthly rent provided by this Agreement, this Agreement shall continue to be binding on the parties as a month-to-month agreement.

WHEREFORE We, the undersigned, do hereby execute and agree to this Lease.

LANDLORDS:	TENANTS:
______________________	______________________
(signature)	(signature)
______________	______________
(date of signature)	(date of signature)
______________________	______________________
(signature)	(signature)
______________	______________
(date of signature)	(date of signature)

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15 · Investment Principles

PERFORMANCE OBJECTIVES

After studying this chapter, you should be able to:

- State how you can save money to build up your investment assets.
- List your investment objectives.
- Design and explain a fundamental strategy for achieving your investment objectives, given the constraints of expected investment return, taxes, and inflation.
- Explain the nature of investment risk.
- Define and explain the fundamental concepts of income, compound yield, liquidity, and maturity.
- Explain the effect of inflation on investment lending positions and on investment ownership positions.

OUTLINE OF THE MAIN IDEAS

I. Despite the fact that most people spend nearly all their income, investing can make the difference between affluence and poverty in your future. For example, if you can get a return of 8 percent on your investment, you can double your investment in nine years.

II. How can you save money in order to invest?
  A. You can budget a certain amount of savings per month.
  B. You can use payroll deductions to be invested in a credit union, savings bonds, or stock in the company; buy a cash value life insurance policy; or invest in a mutual fund.
  C. Use only greenbacks and put change in a jar.
  D. Try a frugality month.
  E. Take advantage of windfalls, such as continuing to save the amount of a monthly payment after your final payment or using a salary raise for savings.

III. Risk and certainty
  A. Risk is the chance of loss in the future.
  B. Certainty is the absence of risk or perfect information about the future.

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  C. Risk declines as the amount of information about the future increases (see Figure 15-1 in the text.)
  D. Risk increases as the rate of return increases (see Figure 15-2 in the text). However, the fact that the risk is high does not guarantee that there will be a return or that it will be high.

IV. There are six *investment-related* risks.
  A. *Inflation risk* is caused by the reduced purchasing power of money resulting from inflation.
  B. *Deflation risk* arises from the reduction of asset values due to price declines in a recession.
  C. *Business risk* refers to adverse events that could reduce or destroy the yields originally expected.
  D. *Interest rate risk* refers to the decline in the market value of an investment as the level of interest rates on new similar investments increases.
  E. *Market volatility risk* arises from the fact that some investment values fluctuate widely.
  F. *Liquidity risk* is the risk that losses might occur if you had to cash in your investment quickly.

V. At various times in the business cycle, some risks have greater impact than others.
  A. In recession, business risk and liquidity risk are greater than inflation risk.
  B. In expansion, inflation risk and interest rate risk are greater than either business or liquidity risk.
  C. Market volatility risks can be reduced by diversifying into investments that do not move together.
  D. One should judge an investment on one's appraisal of the risks during the period of investment. (See Table 15-1 in the text.)

VI. *Investor-related* risk is psychological, involving the risk of emotions of fear and greed that cloud a reasonable approach to investing.

VII. There are basically two ways of reducing risk.
  A. By increasing knowledge through research and experience
  B. By diversifying your investments properly
    1. You may diversity *among* investment media (see guidelines in text).
    2. Diversification *within* investment media themselves reduces business risk, especially in stock and real estate investments.

VIII. You invest today in order to obtain a return in the future. This return may be:
  A. Growth of the principal in the form of price appreciation
  B. Income from the principal
    1. *Interest* is the return to lenders for the use of their money and is expressed as an annual percentage rate.
    2. *Dividends* are distributions of corporate profits to shareholders. Their amount and frequency depend upon the firm's profits and the decision of the board of directors.
    3. *Rent* is the return to owners for the use of their property.
    4. *Capital gains* represent the excess of selling price over the original costs of an asset. If the selling price is less than the costs, it is a capital loss.
    5. *Retirement payments*, such as Social Security, life insurance and annuity payments, are income only to the extent that they exceed the original costs.
    6. *Compound yield* occurs when the income from the investment is reinvested. There are two ways to reinvest.
      a. *Lump-sum investment* involves investing a fixed sum and letting it accumulate (see compound interest Table A in the text).
      b. *Annual investment* involves investing regular annual payments (see compound interest Table B in the text).

IX. Basically, there are only two ways to invest money.
  A. You can lend it at interest in four ways.
    1. Lend to a savings and loan association, bank, or credit union.
    2. Lend to the government or a business by buying bonds.
    3. Lend money to homeowners through second mortgages.
    4. Lend to a life insurance company by buying a cash value policy.

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B. You can own part of an income-producing asset.
   1. Own a common or preferred stock in a corportaion.
   2. Own shares in a mutual fund.
   3. Own a share in a small business.
   4. Own a share in an investment syndicate.
   5. Own a deed to real estate.
   6. Own personal property, such as stamps, coins, or art.

X. Because of inflation, fixed dollar investment returns and lending provide little or no protection against inflation whereas owner-type investments often act as a hedge against inflation (see Table 15-3 in the text).

XI. There are seven relevant characteristics of investment media that investors use to compare their alternatives.
   A. The *overall degree of risk* is affected by the six types of risks discussed earlier.
   B. The *average annual compound yield* is an average of the annual returns of an investment over a period of years.
   C. *Liquidity* describes the ease and rapidity of converting the investment into cash.
   D. The degree of *personal management* required is important to those whose time is too limited to watch over their investments.
   E. *Maturity* in this context means the minimum amount of time you must wait to realize the return you expect.
   F. The *extent of protection against inflation* may also be important for long-term investments.
   G. The *tax aspects* of investments become more significant the higher the tax bracket the investor is in.

XII. Investment goals may be classified in four ways.
   A. Type I—having an emergency fund of two or three months' take-home pay
   B. Type II-A—reaching goals of major importance; and Type II-B—reaching goals of minor importance
   C. Type III-A—having a basic retirement income; and Type III-B—having extra retirement money for travel and other goals
   D. Type IV—building an estate

XIII. Your investment goals may change over time.
   A. From the example of Rich and Debbie, we note the following:
      1. The planning of goals improved their chances of getting what they wanted.
      2. By ranking their goals, they avoided confusing them and the timing of the investments needed to achieve them.
      3. This allowed them to use high-risk investments with potentially high returns for long-term and low-priority goals without jeopardizing security.
   B. The 11-step procedure for planning investments to achieve goals is illustrated using the worksheet for the Andersons.
      1. Enter your investment assets as shown in your balance sheet, less an emergency fund.
      2. From your income statement and budget, estimate the annual amount available for investments.
      3. Decide your goals and rank them in order of importance.
      4. Estimate the amounts needed (in today's dollars) for each goal.
      5. Estimate the number of years you have to achieve each goal.
      6. Estimate the rate at which inflation will affect the amount needed for your goal.
      7. Multiply the inflation factor times the original amount needed.
      8. Decide the diversification and strategy of your investments.
      9. If you plan to use a lump-sum investment to attain a goal, select the appropriate factor from compound interest Table A to arrive at the necessary lump sum; subtract this amount to determine the amount available for other goals.
      10. If you plan to use an annual investment of a regular amount, select the factor from Table B to determine the amount needed; subtract this amount to determine the amount left for other goals.

11. If you run out of funds before your top priority goals are achieved, you have four alternatives.
    a. Revise your budget to increase savings.
    b. Select higher yield investments.
    c. Reduce the amount of some goals and extend the time needed to achieve them.
    d. Wait until one goal is achieved and use funds thus freed up to achieve the next goal.

SELF-TESTING EXERCISES

True-False

______ 1. Both principal and interest on U.S. savings bonds are guaranteed.

______ 2. The greater the degree of risk in an investment, the lower its yield.

______ 3. Interest rate risk and inflation risk are identical since interest rates rise during inflation.

______ 4. Most people spend nearly everything they earn.

______ 5. The measure of the relationship between risk and certainty is often termed the degree of risk exposure.

______ 6. Over a period of one year, one would expect greater market risk from investments in real estate than from common stock.

______ 7. There are basically only two ways to invest money. You can either lend it at interest or use it to own an income-producing asset.

______ 8. The degree of personal management required in an investment should be irrelevant in your choice of an investment.

______ 9. Corporate dividends are not assured.

Completion

1. ______________________ is defined as the chance of loss in the future.
2. The risk that a competitor could discover a better method of copying at less cost than Xerox would be an example of ______________________ risk to the investor in Xerox.
3. ______________________ risk refers to the decline in market values of investments as the level of interest rates on new similar investments rises.
4. There are basically two ways to reduce risk: knowledge and ______________________.
5. The payment you receive for allowing someone to use your property is called ______________________.
6. The yield on an investment that occurs when the returns on the investment are reinvested is called the ______________________ yield.
7. An investment is said to be ______________________ when it can easily be converted into cash.
8. A table that tells the future value of a dollar invested at various rates for various time periods is called a ______________________ table.
9. The procedure for planning investments to achieve goals has ______________________ steps.
10. To determine the amount you have available for investment annually, you use your ______________________ ______________________ or budget.

Multiple Choice

1. If you are concerned about investment risks, you should

   a. diversify your stock and real estate portfolios as much as you can
   b. invest something in each area—time deposits, bonds, stocks, real estate
   c. gain investment knowledge before investing
   d. (All of the above)

2. Generally, rising interest rates in the economy

   a. make everybody richer
   b. tend to increase the value of stocks, bonds, and real estate
   c. tend to reduce the value of stocks, bonds, and real estate
   d. are not of much concern

3. Which of these investments would you buy as a possible inflation hedge?

   a. Savings account
   b. Cash value life insurance
   c. Real estate
   d. Municipal bond

4. Which of these investments usually requires ongoing management by the investor?

   a. Savings account
   b. Real estate syndication
   c. Common stocks
   d. Municipal bond

5. If you invested $2,000 in a 6 percent savings account and had the interest mailed to you each quarter so that you could have extra spending money, how much would your total return be over 10 years?

   a. $120
   b. $1,200
   c. $1,600
   d. $4,800

6. If you left $2,000 on deposit in a 6 percent savings account and let the interest be reinvested to compound annually, how much would your total interest return on the principal be over 10 years?

   a. $1,200
   b. $1,600
   c. $3,600
   d. $22,400

7. If you expected house prices to rise 8 percent per year, compounded, what might a $50,000 house cost in 12 years?

   a. $98,000
   b. $125,000
   c. $220,000
   d. $950,000

8. If each year for five years you bought $5,000 worth of corporate bonds paying 9 percent, how much money could you accumulate?

   a. $25,000
   b. $27,250
   c. $30,000
   d. $38,750

9. If you figure you will need $4,000 to replace your car with a new one in five years, how much would you have to deposit in a 6 percent savings account at the end of each year to reach your goal?

   a. $700
   b. $714
   c. $800
   d. $3,077

10. Mr. Speculator thinks he can obtain an investment return of 4 percent a month. If so, how long would it take him to double his money?

    a. 18 months
    b. 25 months
    c. 28 months
    d. 36 months

Cases and Problems

1. In 1624, the island of Manhattan in New York City was sold by the Indians for $24 worth of beads and trinkets. If the $24 had been invested at 6 percent compound interest for all these years, how much would it have amounted to by 1984?

2. Mr. Maverick, an unusual investment advisor, says, "I don't believe in diversification. Put all your eggs in one good basket and watch that basket very carefully. Diversification means putting your eggs in many baskets and it becomes too hard to watch all of them closely. You can't develop investment expertise in many different areas. Perhaps it is more risky not to diversify, but risk is part of life and one must learn to live with risk." How do you feel about this? Why?

3. Cousin Timid wants you to do an 11-step procedure for him, but wants to take as little money as possible out of his savings account to spend on his goals. Since he doesn't want to spend much time managing his investments, he asks you to restrict your choice of investments to the following three, and hopes to obtain these returns after paying his state and federal income taxes at about the 40 percent combined rate:

   Corporate bonds 5%
   Mutual funds 7% (typical average if held five years or more)
   Real estate syndication 10% (average maturity over seven years)

   He has $20,000 in his savings account, but plans all future savings out of his salary for his eventual retirement. His goals are as follows:

   1. Truck and camper, $4,000 plus present truck trade-in, in 4 years
   2. Asian tour, $5,000 in 7 years
   3. European tour, $4,000 in 10 years
   4. Lake cabin, $15,000 down in 15 years

   (Cousin Timid is not timid about traveling, which he hopes his bachelor life will allow him to afford.) He asks you to assign a 5 percent inflation rate to his plans, except for 6 percent for the cabin. How does the optimum plan look? About how much would be left in his savings account after allocating what he needs for goals?

PERSONAL MONEY MANAGEMENT ACTIVITIES

1. Set out your goals and use the 11-step procedure to determine your own investment strategy to achieve them.

2. Look back over investments you have made in the past, identifying the kinds of risks you ran, the returns you received, and the mistakes you might have made.

3. In the light of economic conditions today, which investment media offer returns commensurate with the risks as you perceive them?

ADDITIONAL ACTIVITIES

In preparation for studying Chapters 16 through 20, look over the chart "Overview of Investment Types" on pages 139-40. As you complete each chapter, refer to the chart again. It will help you see the broad picture while you study the details of each of the potential investments you might make.

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OVERVIEW OF INVESTMENT TYPES TREATED IN CHAPTERS 16 THROUGH 20

Group I: Fixed Dollar Investments

Characteristics	Primary Uses	Classification			Best Opportunities
		Investment Opportunity	Important Advantage	Major Disadvantage	
Interest or dividends earned on a fixed amount of principal	To hold emergency funds To hold temporary or short-term funds for buying certain items or making other investments	Savings account or credit union	High liquidity	No inflation protection	Savings and loan accounts, U.S. savings bonds, insured credit union accounts, life insurance (for forced savings), money market mutual funds
		U.S. savings bond	No state taxes; deferred federal taxes	No inflation protection	
		Life insurance	Forced savings	Lowest rate of return	
		Fixed annuity	Lifetime income	No inflation protection	

Group II: Marketable, Fixed Income Investments

Characteristics	Primary Uses	Classification			Best Opportunities
		Investment Opportunity	Important Advantage	Major Disadvantage	
Fixed income, but can have price fluctuations	Conservative investments with better yields than those available in Group I (without much more management) For two- to five-year investments needs if Group III prospects uncertain	Preferred stock (not convertible)	High yield (sometimes)	Stock prices forced down by rising interest rates with no maturity date redemption	Up to 15-year maturity corporate or municipal bonds, second deeds of trust
		Corporate bonds			
		Maturities of around five years or less	High yield and safety		
		Maturities of 10 to 15 years	High yield	No inflation protection plus price fluctuation problems	
		Municipal bonds	Tax advantage to investors in brackets over 40 percent	Same as for corporate bonds	
		Second deeds of trust	Highest yield and small price fluctuation	Risk of doing business with a poor broker	

Group III: Equity Investments

Characteristics	Primary Uses	Classification			Best Opportunities
		Investment Opportunity	Important Advantage	Major Disadvantage	
Price fluctuations Right to income from an asset Possible hedge against inflation	For all long-term investments (three years or more) to obtain high yields	Common stock	Very high potential return	Significant management required	Common stocks and convertibles (for active investor) Mutual funds and real estate syndicates or trusts (for inactive investor) Carefully selected variable annuity (for retirement)
		Mutual funds	High potential return; little management required	Difficult to outperform market	
		Variable annuity	Lifetime income: no management required	Same management for life	
		Convertible bonds and preferred stock	Higher current income than from common stocks	Significant management required; sometimes overpriced relative to common stocks	
		Real estate syndicates and trusts	High yield; tax shelter; little management required	Requires careful initial selection; lack of liquidity	

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NAME(S)

DATE

WORKSHEET FOR PLANNING INVESTMENTS AND ACHIEVING GOALS

A	B	C	D	E	F1	F2	G	H
Goal	Amount Needed	Years	Inflation Factor[a]	Adjusted Amount Needed (B X D)	Return Factor from Table		Lump-Sum Investment[a] (E ÷ F1)	Annual Investment[b] (E ÷ F2)
					A[a]	B[b]		
Amount remaining								
Amount remaining								
Amount remaining								
Amount remaining								
Amount remaining								
	(To be computed in Chapter 21)			(To be computed in Chapter 21)				
Amount remaining								

[a] Refer to compound interest Table A.

[b] Refer to compound interest Table B.

16 · Fixed Dollar Investments

PERFORMANCE OBJECTIVES

After studying this chapter, you should be able to:

- Define *fixed dollar investment*.
- Explain the difference between nominal interest rate and effective interest rate.
- Describe the four methods of computing interest and how to select the best method.
- Give the four major reasons for investing in time deposits.
- Explain the advantages and disadvantages of fixed dollar investments in general.
- Describe the various types of fixed dollar investments offered by banks, savings and loans, thrift institutions, credit unions, and the federal government.
- Explain how money market mutual funds work.
- Explain how annuities work, their advantages and disadvantages as investments.

OUTLINE OF THE MAIN IDEAS

I. Fixed dollar investments are time deposits in which, in return for your deposit or investment, you receive a fixed return of *interest*.
   A. The *nominal* interest rate is the stated rate of interest.
   B. The *effective* interest rate is the rate you actually receive on your invested savings.
      1. If the interest rate is compounded annually, the effective rate is equal to the nominal rate.
      2. If the interest rate is compounded for any term shorter than a year, the effective rate is higher than the stated rate (see Tables 16-1 and 16-2).
   C. The actual interest paid also depends upon how your balance is computed.
      1. *FIFO* (first in, first out) assumes that the first deposit is the first withdrawn and therefore is least advantageous.
      2. *LIFO* (last in, first out) assumes that the last deposit is the first withdrawn and therefore is better for the depositor.

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  3. Computation of the *daily interest* yields the highest returns to the depositor.
  4. The *low balance* method computes the interest on your lowest balance and yields about the same return as the FIFO method.

II. You should consider your reasons for using time deposits as well as their advantages and disadvantages.
 A. Time deposits are appropriately used for four major reasons.
  1. Emergency funds since they are liquid and accessible
  2. Attaining special goals such as a car, thus eliminating finance charges of borrowing and accumulating interest for yourself
  3. A safe investment with an assured income
  4. Temporary investments in order to accumulate funds for other investments
 B. The advantages of time deposits include guaranteed value in dollars, insured by the federal government up to $40,000 per account, an assured income, lack of transaction costs, and liquidity.
 C. The disadvantages of time deposits are that their returns are lower than most other investments and their inflation protection is poor.

III. There are various types of time deposits offered by various institutions.
 A. *Commercial banks* offer various kinds of accounts and certificates of deposit (CDs).
  1. *Regular* passbook savings accounts
   a. *Individual* accounts have one owner.
   b. *Joint tenancy* accounts have more than one owner with each owner having access.
   c. *Tenancy in common* accounts require the signatures of both owners for withdrawal.
   d. *Trustee* accounts are owned by adults for children who cannot withdraw without the adult's signature and upon which taxes must be paid by the adult on the interest income.
   e. *Minors'* accounts are for children with permission of parents if the child can sign his or her name. Since the minor is the owner, the minor pays any taxes on the interest.
   f. *Fiduciary* accounts are opened in the name of estates by executors or in the name of minors or incompetents by their guardians.
  2. *Bonus* savings accounts are those that pay a slightly higher rate upon stipulated conditions, such as a minimum balance or minimum holding period.
  3. *Club* accounts enable you to budget savings for specific goals, such as Christmas gifts or vacations. (Sometimes there is little or no interest and you would be better off in another type of account.)
  4. *Small scale CDs* are also called savings certificates, bank bonds, or guaranteed income bonds.
   a. They are issued in amounts from $25 to $1,000 and in multiples thereof.
   b. The interest is guaranteed until maturity, which ranges from 1 to 10 years.
   c. The interest may be paid to you or it may accrue (be added) to the cash-in value of the bond.
   d. If the interest accrues at a constant rate until maturity, it is called a *fixed-interest-rate* bond.
   e. If the interest rises over time to maturity, it is called a *rising-interest-rate* bond. This type penalizes you if you cash it in before maturity, but may have a tax advantage since most of the interest accrues in the later years when you may be in a lower tax bracket.
   f. The *deferred income bond* pays all interest in a lump sum at maturity.
   g. To withdraw funds, you must wait three months or for a three-month anniversary, or else pay an interest penalty
  5. *Large scale CDs* have face amounts of $100,000 and up, are negotiable (that is, may be sold to third parties), and offer the highest rates available.
 B. *Mutual savings banks* pay dividends at an established rate out of earnings. The dividend rates are higher than the bank rates but are not guaranteed. They are federally insured up to $40,000 in one name. Some of these accounts, called NOW (negotiable order of withdrawal) accounts, allow checks to be written against them and are interest-bearing checking accounts.

C. *Savings and loan associations* stimulate the building industry by accumulating savings that they invest in residential real estate mortgages. Dividends are paid out of the associations earnings.
  1. They may be mutual or corporate (stock) companies.
    a. *Mutuals* are owned by depositors (share owners), who usually have one vote for members of the board of directors per $100 deposit.
    b. *Corporates* are owned by stockholders. Many pay interest instead of dividends.
  2. Dividends are not guaranteed but interest is. There are two major types of deposits.
    a. *Regular passbook* accounts are much the same as at a bank. Dividends or interest may be sent to you or left to be compounded.
    b. *Bonus or certificate* accounts are issued in multiples of $1,000 and may offer a 0.25 to 2.5 percent rate of return depending on the size of deposit. Maturities vary from 90 days to six years.

D. *Thrift institutions* make small personal loans and, since they are not usually insured, their dividends or interest rate may be 9 or 10 percent.

E. *Credit unions* are associations of persons with a common interest who pool their savings to provide low-cost loans to members.
  1. There are several advantages to using credit unions.
    a. They provide payroll savings plans.
    b. They offer high dividend rates.
    c. They offer free life insurance protection.
  2. The *disadvantages* are a lack of privacy and safety unless deposits are insured.

F. *U.S. government savings bonds* are one way of financing the federal government.
  1. Series E bonds (sold only until January 1980) were sold at three-fourths of their face value to yield 6.5 percent annual average rate if held to maturity (five years).
  2. Series H bonds (sold only until January 1980) were current income bonds bought at face value in multiples of $500 at 6 percent interest paid twice yearly until maturity.
  3. Series EE bonds, which replace E bonds, are issued at 50 percent of their face value in minimum denominations of $50, with a maturity of 11 years, 9 months.
  4. Series HH bonds, which replace Series H bonds, pay 6.5 percent interest and are subject to an interest penalty if redeemed before maturity.
  5. The advantages of savings bonds are that they are insured, the interest is guaranteed, they are easily replaced and conveniently available. There are certain tax advantages as well.
  6. The disadvantages are low rates of return and loss of flexibility in cash resources.

IV. *Money market mutual funds*, which are pools of money invested in bank certificates of deposit and U.S. government securities, combine good interest returns with flexibility. They have three distinguishing features.
  1. The interest rate is variable, ranging from 5 to 12 percent, and is compounded daily.
  2. Deposits are not federally insured; however, because investments are in government securities and large, financially strong institutions, you can be sure your deposits will be returned to you plus interest.
  3. You have the privilege of writing large checks against your account.

V. Annuities provide monthly income for life.
  1. They may be *fixed* or *variable*.
  2. The *maturity date* is the date your monthly payments begin.
  3. The *accumulation period* is the time before the maturity date.
  4. The *distribution period* begins on the maturity date.
  5. Two endorsements may be added to annuities.
    a. The *disability waiver of premium* endorsement calls for the company to continue paying your premiums if you become disabled.
    b. Term life insurance may also be added to your annuity.

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6. There are advantages and disadvantages to annuities.
    a. Advantages are forced savings and tax deferral.
    b. Disadvantages are a relatively lower yield than other investments, little inflation protection, and lack of flexibility in changing companies.
7. Annuities are purchased from insurance companies.
    a. You may buy them with a lump-sum payment or with the settlement options of your life insurance policy.
    b. You may also purchase them in installment payments.

SELF-TESTING EXERCISES

True-False

______ 1. More people use fixed dollar investments than any other investment medium.

______ 2. The FIFO computation of the deposit yields higher returns than LIFO.

______ 3. Each owner of a tenancy in common account must sign the withdrawal slip in order to withdraw funds.

______ 4. Trustee accounts are owned by minors who must pay taxes on the interest.

______ 5. Large-scale CDs are non-negotiable.

______ 6. On all savings certificates, you have to wait at least three months to withdraw your funds.

______ 7. Dividends paid out of profits by savings and loan associations are not guaranteed.

______ 8. Credit unions offer free term life insurance matching deposits dollar for dollar up to $1,000 or $2,000.

______ 9. The loss record of credit unions is very low.

______ 10. Series E or EE bonds can be exchanged for Series HH bonds on a tax-free basis.

Completion

1. Lack of privacy is a disadvantage of depositing in ______________________.
2. Mutual savings bank accounts that allow checks to be written against them are called ______________________ ______________________ accounts.
3. Government savings bonds that pay a steady 6.5 percent are called ______________________ bonds.
4. Deposits in commercial banks are federally insured up to $______________________ per account.
5. Accounts that pay a slightly higher rate if a minimum balance or minimum holding period is maintained are called ______________________ accounts.
6. If the interest on a bank bond rises at an increasing rate until maturity, it is called a ______________________ ______________________ bond.
7. The ______________________ rate of interest is the stated rate of interest.
8. Time deposits offer little protection against ______________________.
9. The ability to write checks against your account is offered by ______________________ banks and ______________________ funds.

Multiple Choice

1. Membership in a credit union may offer

   a. enforced savings through payroll deductions
   b. free matching term life insurance on accounts up to $2,000
   c. dividends dependent on earnings
   d. low-interest loans
   e. (All of the above)

2. For an important goal two years from now, your best alternative would be

   a. U.S. government Series EE bond
   b. U.S. government Series HH bond
   c. a two-year bank passbook account
   d. a two-year savings and loan certificate

3. Money market mutual funds offer

   a. check writing against your account
   b. variable interest
   c. no federal deposit insurance
   d. good safety because of the way they invest
   e. (All of the above)

4. You would definitely prefer an institution that pays interest via which method?

   a. Daily interest
   b. Low balance
   c. FIFO
   d. Monthly interest

5. Which of the following would be attractive to a person who expects to be in a much lower tax bracket in a few years?

   a. Bank certificate of deposit
   b. A savings and loan six-year certificate
   c. Credit union account
   d. U.S. savings bonds
   e. Money market mutual fund

6. Time deposits are best used for

   a. long-term investments
   b. investment gifts to children
   c. your emergency funds and accumulations for short-term goals
   d. investments for high-bracket taxpayers

7. The best justification for investing in time deposits is

   a. security
   b. possibility of high returns
   c. good tax advantages
   d. hedge against inflation
   e. (All of the above)

8. Which refers to a method of computing interest?

   a. NOW
   b. Low balance
   c. High balance
   d. FSLIC

9. Features that distinguish money market mutual funds from other time deposits are

   a. variable interest rates
   b. lack of federal deposit insurance
   c. the ability to write checks against your account
   d. (All of the above)

10. Which of the following describes thrift institutions?

    a. They may offer dividends or interest up to 9 or 10 percent.
    b. They make small personal loans.
    c. They are not usually insured.
    d. (All of the above)

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Cases and Problems

1. Sharon deposits $100 each month in a 5 percent savings account. She deposited $100 at the beginning of the first and second months but withdrew $100 at the end of the second month and made no further deposits during the quarter. What amount of interest would be credited to her at the end of the quarter:
   a. if the bank used the FIFO method of computing her balance?
   b. if the bank used the LIFO method of computing her balance?
2. Tony is a busy tycoon making good income from his real estate business. As fast as he makes money, he buys CDs paying 10 percent if deposited for three years. He's not interested in other kinds of investments because he feels they aren't any better than his 10 percent certificates. Tony is in the 40 percent tax bracket and inflation is currently 7 percent a year. What is Tony's after-tax-and-inflation return?
3. Using compound interest Table A, determine the difference in values over 10 years of an emergency fund of $3,000 invested in:
   a. a 5 percent passbook savings account
   b. an 8 percent four-year certificate of deposit
4. Tom is receiving a 7 percent return on his deposit with the credit union. Chet tells him that last year he had a return of 11 percent from a money market mutual fund. Tom is tempted by Chet's return and asks your advice.

PERSONAL MONEY MANAGEMENT ACTIVITIES

1. Using the addresses listed in your text (p. 380), send for the prospectuses of several money market mutual funds and find out their current interest rates, their managerial fees, and the minimum check amount you may write.
2. At the institutions where you have deposits find out:
   a. their methods of computing balances
   b. whether your deposits are insured
   c. the rates and maturities of their CDs

17 · Stocks and Bonds

PERFORMANCE OBJECTIVES

After studying this chapter, you should be able to:

- Define and explain the basic concepts of common stocks, preferred stocks, corporate bonds, and preferred bonds.
- Classify corporations by their basic characteristics of size, position in the industry, growth rate, dividend yield on stocks, and stability.
- Explain the basic factors that affect stock prices.
- Describe when the stock market would be an appropriate investment medium.
- Explain when it would be wise to invest in bonds and how such an investment should be made.

OUTLINE OF THE MAIN IDEAS

I. There are five general types of securities: common stocks, preferred stocks, bonds, convertible preferred stocks, and convertible bonds. Table 17-1 in the text shows how these may be compared according to their potential for income, capital gains, voting rights and their claims on the assets if the company is liquidated.
   A. *Common stock* represents ownership interest in a corporation.
      1. For the stockholder, common stock investments offer three basic rights.
         a. The right to corporate income, which may be realized as cash dividends and/or capital appreciation through corporate growth
         b. The right to control the company by electing the board of directors
         c. Upon liquidation, the right to whatever corporate assets remain after all debts, bondholders, and preferred stockholders have been paid in full
      2. For the company, common stock provides funds for working capital, growth, acquisitions, or debt payments.
      3. The total return on common stock is the sum of the dividend yield and the capital gain or loss.

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4. There are several terms that the common stock investor should understand.
   a. *Earnings per share* (EPS) is the result of dividing the after-tax profits of the corporation by the number of shares outstanding.
   b. The *price/earnings (P/E) ratio* (or P/E multiple) is the ratio of a stock's market price to its EPS.
   c. *Par value*, in the past, was the level below which a company would not sell shares. Today the figure is of no significance to the investor.
   d. *Cash dividends* are a distribution of the firm's earnings to its owners (stockholders) in cash. The dividend divided by the market price is called the *dividend yield.*
   e. *Stock dividends* are new shares distributed to stockholders in proportion to their holdings and merely represent the division of ownership into smaller pieces. In general, the stockholders own the same share of the corporation that they owned before.
   f. *Stock splits* are the same as stock dividends but on a larger scale.
   g. *Book value* is equal to the corporation's assets minus its liabilities. The *book value per share* is the book value of the company divided by the number of outstanding shares.
5. It is useful to classify stocks into five categories to aid in portfolio management decisions.
   a. *Growth stocks* are stocks of large companies whose earnings are growing at increasing rates. These companies pay low or no dividends, but the stocks have high P/E ratios since investors expect high earnings in the future.
   b. *Second-tier growth stocks* are similar to growth stocks except they are smaller, are issued by less well-known companies, and have lower P/E ratios.
   c. *Mature growth stocks* are those of large, stable, slow-growth companies that pay above-average dividends. They tend to have low P/E ratios.
   d. *Cyclical stocks* are those whose earnings per share rise and fall with the business cycle.
   e. *Special situation stocks* are those that do not fit into the above categories.
6. Common stock prices fluctuate for reasons seldom agreed upon by experts.
   a. Common stock prices partly reflect *fundamental factors* such as earnings history, stability, and future prospects, yield, P/E ratios, and book values.
   b. They also reflect *technical factors* (characteristics of the market itself) such as a temporary imbalance in supply and demand and general investor psychology.
7. Common stocks offer certain advantages and disadvantages for the investor.
   a. The advantages include a high potential return, long-term capital gains tax treatment, and a $100 exemption from gross income for dividends.
   b. The disadvantages include high market volatility, inflation and interest rate risks, and the need for experience, expertise, and attention in managing the portfolio.
8. There are several things to keep in mind when buying common stock.
   a. Determine the EPS and the growth rate of the company to estimate what your return from that stock may be.
   b. Compute the average P/E ratio for the stock over a period of years to determine the "average right price" of the stock.
   c. Determine the high and low ends of the P/E ratio range so that you can plan to buy the stock at a below-average price.

B. *Preferred stock* represents a limited ownership in the corporation. Little preferred stock is issued any more except by utility companies.

1. The dividend, while more assured, is fixed in amount and generally offers no participation in the growth of the corporation.
2. Interest on bonds is paid first, then preferred stock dividends are paid (if there are earnings).
3. Some companies issue two classes of preferred stock: *first preferred* and *second preferred.*
4. Dividends depend upon declaration by the board and might be missed unless there is a cumulative dividend provision.
5. Although preferred stockholders have a claim to assets prior to that of the common stockholders, they have no voting rights.
6. Preferred stocks are questionable as investments since their price fluctuates like that of common stocks without offering growth potential; like bonds, they offer a fixed income, but without the guaranteed redemption that bonds have.

C. *Bonds* are long-term debts. They represent a loan to a corporation or a government body and are guaranteed to be repaid at a specified date.

1. *Corporate bonds* have face amounts of $1,000 and maturities of 20 to 30 years.
    a. Bond prices are quoted in terms of percentage of *face value* (also called *par value*).
    b. There are four basic types of corporate bonds.
        (1) *Mortgage bonds* are secured by real estate.
        (2) *Collateral trust bonds* are secured by collateral other than real estate.
        (3) *Debentures* are basically promissory notes.
        (4) *Subordinated debentures* are less secure than debentures, since they are paid only after other creditors are paid.
    c. The degree of safety of a bond depends upon the type of bond and is reflected in ratings by Standard and Poor's or Moody's manuals.
    d. Interest on a corporate bond is fixed and is paid twice a year.
        (1) Interest on an *income bond* is paid only if the company earns sufficient profits.
        (2) *Coupon bonds* require the holder to clip a coupon and send it in to collect the interest.
        (3) *Registered bonds* pay interest without one's having to send in any coupons.
    e. If the general long-term interest rate rises, bond prices fall and vice versa.
    f. Bond prices reflect changes in the long-term interest rate and changes in the bond's financial rating.
    g. A *call feature* allows the company to repurchase the bond at a set price on a future date.
    h. The total return on a bond is the sum of its interest yield (*effective yield to maturity*) plus any capital gain or loss on resale or at maturity.
    i. Investors buy corporate bonds for five major reasons.
        (1) To diversify their portfolios
        (2) To get a guaranteed return of principal (if held to maturity)
        (3) To get an assured income from fixed interest payments
        (4) For security (if issued by a substantial company)
        (5) To take advantage of low purchase cost
    j. There are two major disadvantages to buying bonds.
        (1) Small changes in the interest rate can produce large changes in the value of your principal.
        (2) Bonds are not a hedge against inflation, since rising interest rates lower bond prices and the face value of bonds does not increase.
2. *Government bonds* are issued to finance federal budget deficits, to provide working capital, and to pay off earlier bonds as they mature.
    a. *Government notes and bonds* are similar to corporate bonds and pay semiannual interest via coupons. They are sold at irregular intervals.
    b. *Treasury bills* pay "interest" by selling them at a discount from face value. These are sold weekly.
    c. The primary advantage of government securities is their safety but they also offer the lowest current yields.
3. State and municipal governments issue *municipal bonds* to raise money, typically for construction projects. Their importance lies in their exemption from federal taxation.
    a. The *general obligation* bonds of states generally offer the highest degree of security.
    b. *Revenue bonds* (such as tolls) are not as secure.
4. Bond investors should buy bonds that suit their income tax circumstances and buy only highly rated bonds selling at a discount from their maturity value.
5. *Convertible bonds and preferred stocks* may be exchanged for a fixed number of shares of common stock, thereby offering the potential returns of common stock but with the security of the bond.

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SELF-TESTING EXERCISES

True-False

______ 1. In the 1970s, common stock returns were below the returns of savings accounts.

______ 2. The earnings/price ratio and the price/earnings multiple are different names for the same thing.

______ 3. Stock dividends represent an increase in the value of the investor's holdings.

______ 4. Growth stocks pay high dividends and have high P/E ratios.

______ 5. The major determinant of the price of common stock is the law of supply and demand.

______ 6. Among the technical factors influencing the price of a stock is its dividend yield.

______ 7. After the preferred stockholder receives a stipulated dividend, he or she shares proportionately in the distribution of profits with the common stockholder.

______ 8. Bonds are not a good hedge against inflation.

______ 9. The P/E ratio is one of the key figures in determining the worth of a common stock investment.

Completion

1. Of the more than 30 million Americans who owned stock in 1975, half had annual incomes of less than ______________.
2. Between 1926 and 1960 a broadly diversified portfolio of common stock realized a ______________ percent average annual compound rate of return; during much of the 1960s the portfolio would have yielded an average of ______________ percent.
3. The dividend yield on common stock is obtained by dividing the dividend per share by its ______________.
4. Stocks of companies that are leaders in their industry pay low or no dividends at all, have increasing rates of earnings growth and high P/E ratios, and are classified as ______________ stocks.
5. Stocks of companies with good, stable earnings and above-average dividends such as electric utilities are classified as ______________ stocks.
6. Preferred stock which provides that arrears in dividends must be paid to its holders before any dividend may be paid to holders of common stock has a ______________ dividend provision.
7. Bond prices ______________ when the prevailing long-term interest rates increase.
8. The interest on ______________ bonds is exempt from federal taxes.
9. Bonds that may be exchanged for a fixed number of shares of common stock of the issuing company are called ______________ bonds.
10. On ______________ bonds, the company is obligated to pay interest only if the company earns enough profit to pay all or a part of the interest due.

Multiple Choice

1. The DEF Corporation has an average of 25 million shares outstanding and had an after-tax net income of $100 million of which it paid out $40 million in dividends. Its earnings per share are

   a. $2.50
   b. $3.00
   c. $3.50
   d. $4.00
   e. $5.00

2. If the market price of DEF above is $48 per share, what is its P/E multiple?

   a. 4.8
   b. 9.6
   c. 12
   d. 16
   e. 24

3. What is the dividend per share of DEF above?

   a. $ .63
   b. $1.60
   c. $3.00
   d. $3.20
   e. $4.00

4. What is the dividend yield on the DEF stock above?

   a. 3⅓%
   b. 4½%
   c. 5%
   d. 5½%
   e. 6%

5. If the directors declared a 10 percent stock dividend on the DEF stock, what would be the earnings per share of stock dividend?

   a. $2.70
   b. $3.00
   c. $3.64
   d. $3.80
   e. $4.50

6. General Motors sells more cars in good times than bad, and its EPS and dividend payouts reflect this fact. It should be considered what kind of stock?

   a. Growth
   b. Second-tier growth
   c. Mature growth
   d. Cyclical
   e. Special situation

7. Preferred stocks

   a. offer a relatively assured fixed income
   b. seldom have voting rights
   c. are questionable as investments
   d. generally do not share in the firm's growth
   e. (All of the above)

8. Which type of municipal bonds offer the highest degree of safety?

   a. Revenue bonds
   b. School district bonds
   c. General obligation bonds of a state
   d. General obligation bonds of a major city

9. Advantages investors seek when buying bonds are

   a. diversification of their portfolios
   b. guaranteed return of principal if held to maturity
   c. protection against inflation
   d. (All of the above)
   e. (Both a and b)

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10. Advantages investors seek when buying common stock are

a. potential returns of 8 to 9 percent per year
b. a hedge against long-term inflation
c. potential tax savings on long-term capital gains
d. (All of the above)

Cases and Problems

1. Using the three-step procedure in the text (page 410), compute the effective yield on an XYZ Company $1,000 bond maturing in four years that pays $75 annually and can be purchased at 92.

2. Complete the blanks in the following table. There is only one stock in each type of market group.

	5-Year Compound EPS Growth	Stock Price	Cash Dividend	Current EPS	P/E Ratio	Dividend Yield
a. Market type: ____________ ABC Auto Company 100,000,000 shares outstanding $500,000,000 latest year's profits	− 3%	$40	$3.20	____	____	____
b. Market type: ____________ Pay More Drugstores 10,000,000 shares outstanding __________ latest year's profits	+ 10%	____	$ .88	$4	11	2%
c. Market type: growth General Electrosoup __________ shares outstanding $120,000,000 latest year's profits	+ 10%	$40	$ .40	$2	____	____
d. Market type: mature growth Plodahead Industries 100,000,000 shares outstanding $400,000,000 latest year's profits	+ 7%	____	____	____	10	6%
e. Market type: special situation Questionmark Products 6,000,000 shares outstanding $6,000,000 latest year's profits	+ 5%	$30	none	____	____	____

3. Your well-to-do Aunt Susan turned over $20,000 to you to manage for her while she spent two years traveling, and she wanted you to invest in stocks and bonds. The following are your results after commissions, but before taxes.

	Total Purchase Cost	Dividends or Interest Received Year 1	Dividends or Interest Received Year 2	Total Sales Proceeds
Stock A	$3,000	$140	$146	$2,900
Stock B	$3,000	120	60	1,800
Stock C	$3,000	150	180	3,300
Stock D	$3,000	80	82	4,600
5 Municipal A bonds	$4,000	200	200	4,200
5 Municipal B bonds	$4,000	220	220	4,300

The Dow Jones averages showed the market was largely unchanged over the two-year period. What is your total dollar profit or loss on the portfolio? How does this compare with what she would have received had she put her money in a 6 percent savings account? If she is in a 40 percent marginal tax bracket because of other interest and dividend income, what is her after-tax return on this portfolio? How does this compare with the 6 percent savings account? Should she be happy with your results? How would you feel if all she did upon seeing the results was to complain about that lousy investment you made in stock B?

4. Pan American Airways convertible bonds, expiring in 1998, pay $75 per year interest and are convertible into 143 shares of common stock. Assume that the stock, which pays no dividend, is selling at $6^{1}/_{8}$ ($6.12/share) and the convertible bond at 88 ($880 per bond) in 1980.
   - a. What is the current yield on the bond? What is its yield to maturity?
   - b. What is the current yield on the common stock?
   - c. What is the conversion value of the bond (its value if converted into stock)? What is the premium over conversion value?
   - d. Which would you buy?

PERSONAL MONEY MANAGEMENT ACTIVITIES

Familiarize yourself with *Standard and Poor's Stock Guide* and *Bond Guide,* which may be in your library or in a broker's office, and look up the ratings, dividend yield, EPS for the last five years, P/E ratios, price ranges, and other data on corporations in which you may have an interest. Look up the bond issues of these same companies noting their current yields and prices, whether or not they are convertible and the conversion ratio if they are, and especially their ratings.

ADDITIONAL ACTIVITIES

1. Select 10 companies in your part of the country, or, simply, 10 companies that you know of, and get information on them from the library or a stockbroker's office, using the sources listed at the end of Chapter 18. How would you classify these stocks into the five market types? Are there any surprises to you?
2. Examine the stock certificate shown on pages 155–56. It has an investor's name on it, but can be sold by anyone once the investor has signed it on the back. How much information about the company can be gained from this certificate? Although this is the investor's primary evidence of ownership, the certificate can be replaced, for a fee, if lost or stolen, especially if the investor has a record of the serial number (in this case, SFG 229104). Obviously, there isn't much need to be able to refer to one's stock certificates, so they are best kept in one's safe-deposit box.

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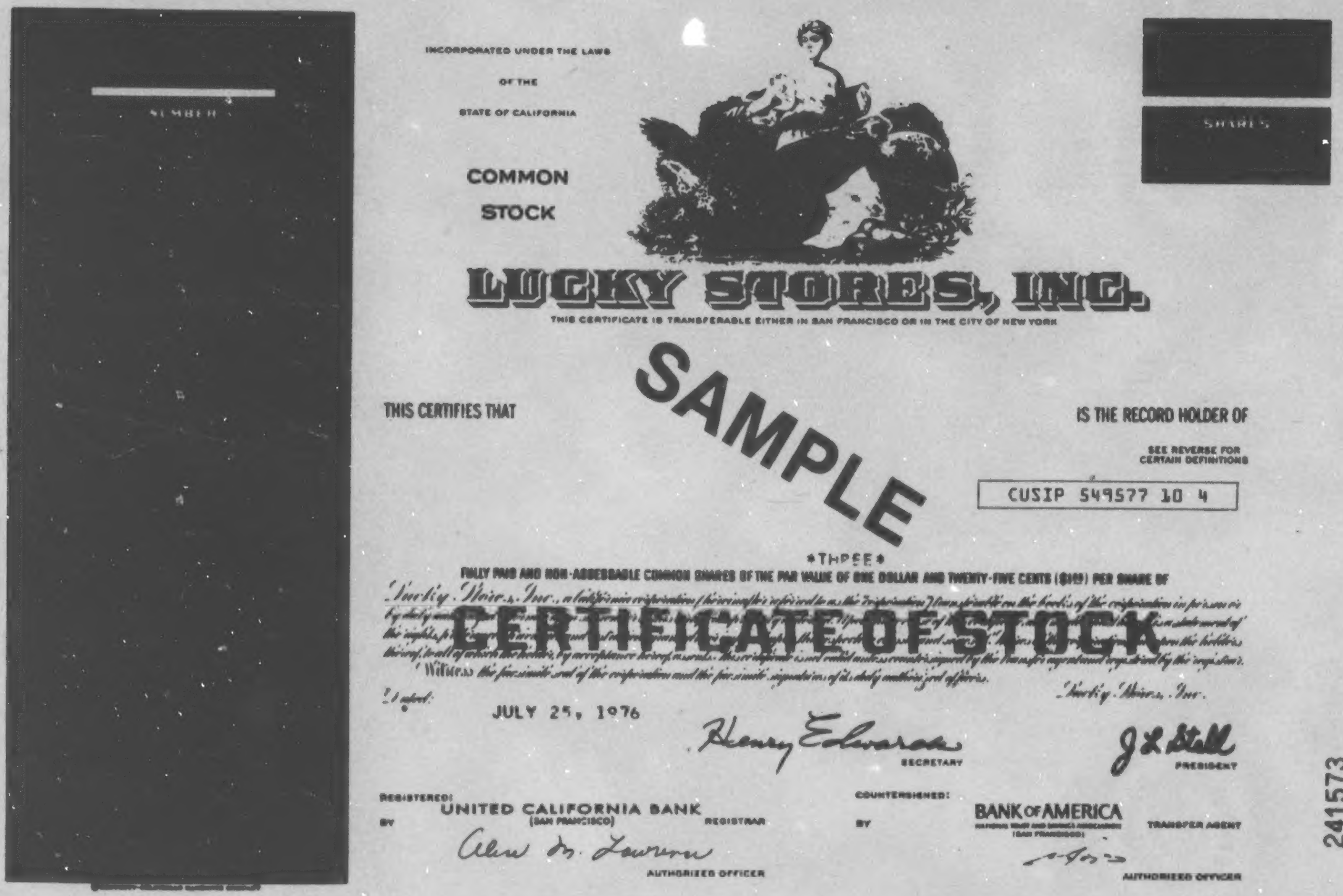


NUMBER

SHARES

INCORPORATED UNDER THE LAWS
OF THE
STATE OF CALIFORNIA

COMMON
STOCK

LUCKY STORES, INC.

THIS CERTIFICATE IS TRANSFERABLE EITHER IN SAN FRANCISCO OR IN THE CITY OF NEW YORK

SAMPLE

THIS CERTIFIES THAT

IS THE RECORD HOLDER OF

SEE REVERSE FOR
CERTAIN DEFINITIONS

CUSIP 549577 10 4

THREE

FULLY PAID AND NON-ASSESSABLE COMMON SHARES OF THE PAR VALUE OF ONE DOLLAR AND TWENTY-FIVE CENTS ($1.25) PER SHARE OF

Lucky Stores, Inc., a California corporation (hereinafter referred to as the Corporation) transferable on the books of the corporation in person or by duly [illegible] statement of the rights [illegible] the holder thereof, to all of which the holder, by acceptance hereof, assents. This certificate is not valid unless countersigned by the Transfer Agent and registered by the Registrar.

Witness the facsimile seal of the corporation and the facsimile signatures of its duly authorized officers.

CERTIFICATE OF STOCK

Dated: JULY 25, 1976

Lucky Stores, Inc.

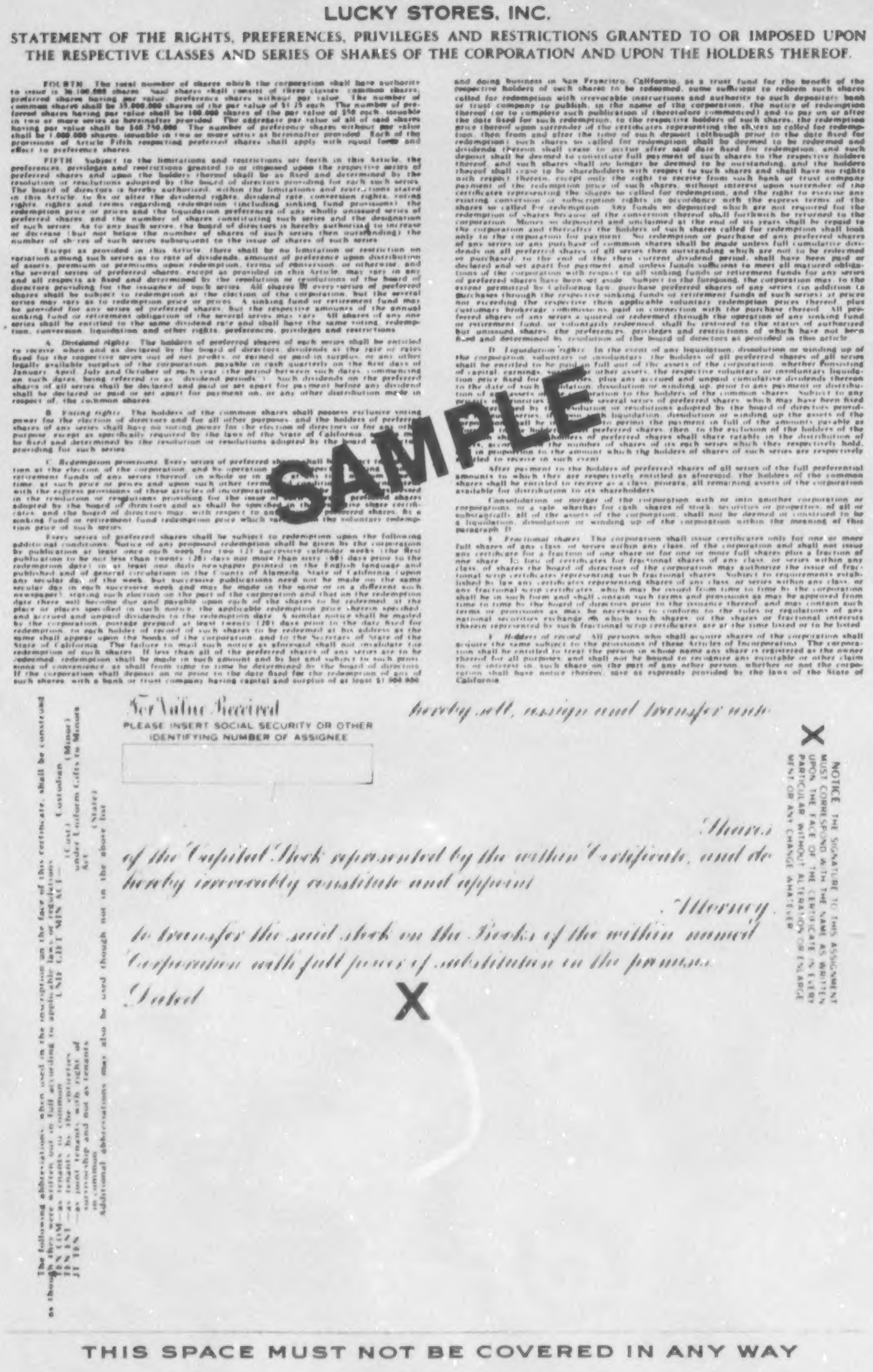
Henry Edwards
SECRETARY

J L Stell
PRESIDENT

REGISTERED:
UNITED CALIFORNIA BANK
(SAN FRANCISCO)
BY REGISTRAR
Alan M. Lawrence
AUTHORIZED OFFICER

COUNTERSIGNED:
BANK OF AMERICA
NATIONAL TRUST AND SAVINGS ASSOCIATION
(SAN FRANCISCO)
BY TRANSFER AGENT
AUTHORIZED OFFICER

241573



LUCKY STORES, INC.

STATEMENT OF THE RIGHTS, PREFERENCES, PRIVILEGES AND RESTRICTIONS GRANTED TO OR IMPOSED UPON THE RESPECTIVE CLASSES AND SERIES OF SHARES OF THE CORPORATION AND UPON THE HOLDERS THEREOF.

SAMPLE

The following abbreviations, when used in the inscription on the face of this certificate, shall be construed as though they were written out in full according to applicable laws or regulations:

TEN COM—as tenants in common

TEN ENT—as tenants by the entireties

JT TEN—as joint tenants with right of survivorship and not as tenants in common

UNIF GIFT MIN ACT— .... Custodian ....
(Cust) (Minor)
under Uniform Gifts to Minors Act ....
(State)

Additional abbreviations may also be used though not in the above list

For Value Received, ... *hereby sell, assign and transfer unto*

PLEASE INSERT SOCIAL SECURITY OR OTHER IDENTIFYING NUMBER OF ASSIGNEE

☐

Shares

of the Capital Stock represented by the within Certificate, and do hereby irrevocably constitute and appoint

Attorney

to transfer the said stock on the Books of the within named Corporation with full power of substitution in the premises.

Dated

X

X

NOTICE: THE SIGNATURE TO THIS ASSIGNMENT MUST CORRESPOND WITH THE NAME AS WRITTEN UPON THE FACE OF THE CERTIFICATE IN EVERY PARTICULAR WITHOUT ALTERATION OR ENLARGEMENT OR ANY CHANGE WHATEVER.

THIS SPACE MUST NOT BE COVERED IN ANY WAY

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18 · Buying and Selling Stocks and Bonds

PERFORMANCE OBJECTIVES

After studying this chapter, you should be able to:

- Explain the functioning of the primary and secondary markets for securities.
- Explain how you would obtain the information needed for securities investing.
- Read and explain the meaning of newspaper stock price tables and the stock market averages.
- Explain how to select a stockbroker and utilize his or her services.
- Define and explain the basics of bull and bear markets.
- Describe how and when to use the basic types of stock market transactions—especially market, limit, and stop orders as well as odd lot transactions.
- Construct a diversified stock portfolio that will perform approximately as well as its beta would predict relative to the market indices.

OUTLINE OF THE MAIN IDEAS

I. *Securities markets* is a term used to describe the process by which companies issue new stock and by which already issued stock is bought and sold among investors.
    A. *Primary markets* involve the issuing of new stock to raise money for the corporation, and this function is generally handled by investment bankers.
        1. The bylaws of some companies require that new offerings first be made to existing shareholders, so the company itself will issue *rights*, on a pro rata basis, to buy shares at the offering price, without a commission. Until these rights expire, they can be traded among investors.
        2. *Warrants* are functionally the same as rights to an investor, although there is a different reason for their issue.

B. *Secondary markets* involve buying and selling securities among investors. The issuing corporation no longer has any stake in the transfer of funds.
   1. Organized exchanges, such as the New York and American Stock Exchanges, have a central trading floor, minimum requirements for a stock to be listed with the exchange, and certain operating rules.
   2. The over-the-counter (OTC) market is not a centralized stock exchange; it is simply a mechanism whereby brokers negotiate trades among their own clients and with other brokerage firms. Two prices are always quoted for OTC stock.
      a. *The bid price* is the price at which a broker would buy the stock from you.
      b. *The asked price* is the price at which a broker would sell you the stock.

C. The securities markets are quite heavily regulated by the Securities and Exchange Commission (established in 1933), state regulatory bodies, and by the National Association of Securities Dealers in order to reduce fraud, manipulation, and concealed information.

II. Considerable information is available to the investor.

A. The bibliography on pages 453–55 of the text offers sources of information on the markets, the economy, and specific companies.

B. Newspapers offer daily market information and news.
   1. Most major stocks are listed each day showing the dividend amount, P/E, trading activity, and current prices.
   2. The Dow Jones averages illustrate the average price trends of a few hand-picked stocks.
   3. The Standard and Poor's averages use the 500 generally larger corporations, but weights each stock's contribution to the average by its outstanding dollar value.
   4. The New York Stock Exchange index is also weighted in favor of the large companies, but includes all NYSE stocks.
   5. The American Stock Exchange lists smaller companies.

III. Brokers and brokerage houses are licensed to handle securities transactions—buying and selling common and preferred stocks, bonds, and mutual fund shares—for all who wish to use their services.

A. *General brokerage firms* offer a full line of services to their customers (for which your commission costs are generally at the high end of the range), including research information and the safekeeping of your securities.

B. *Specialty brokerage houses* usually deal only with persons who maintain large accounts.

C. Brokerage houses are regulated by the SEC and have ethics that require them to keep your financial condition confidential.

D. Brokers receive a commission on each transaction. These costs typically range from 1 to 5 percent of each transaction depending on the size of the transaction, the brokerage firm you're dealing with, and your ability to negotiate and shop.

E. *Discount houses* charge reduced rates because they do not offer extra services.

F. Typical brokerage house services include a monthly statement, written analyses of stocks upon request, telephone quotations, telequote machines for your use, reference materials, and safekeeping of securities.

G. Brokerage houses do their own investment research, but may specialize in one area or have an interest in a certain stock. You should identify a researcher whose work you can rely on.

H. If you want advice, it is important to select a broker who has personal investment objectives similar to your own and who is willing to provide service to you.

IV. Rising stock markets are called *bull markets* and indicate generally favorable economic conditions. Declining markets are *bear markets*, which often mean the economy is headed for a period of unemployment, inflation, or other problems.

A. As an investor, you want to buy and sell at the most profitable times. The long-term investor who wishes to buy and hold for the general upward trend may use:
   1. *Market orders* to buy or sell "at the market"
   2. *Limit orders* to buy or sell only at a certain price or better
   3. *Stop orders* to sell if a stock drops below a certain price

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    4. *Odd-lot transactions* involving fewer than 100 shares (a round lot)
    5. *Dollar cost averaging,* which involves regularly investing a fixed dollar amount in the same stock over a long period of time. This helps guard against buying high and selling low.
  B. The short-term trader can use the above plus:
    1. *Short sales,* wherein you sell the stock and later buy it back. You will profit if the price of the stock declines, but will lose if it goes up.
    2. *Buying on margin,* wherein you borrow money from the brokerage firm to buy more stock than you have cash for, thereby increasing your margin of profit or loss on your cash resources.
    3. *Puts* or *calls*—rights to sell or buy 100 shares of a stock at a given price within a specified period of time. They are technical tools suitable only for the experienced investor.
      a. A *straddle* is buying a put and a call on the same stock.
      b. *Hedging* is selling a call option on a stock already owned.
    4. *Charts* or other specialized short-term trading tools may help to "beat the market" depending on the skill, judgment, and luck of the investor.

V. The *efficient market theory* says that no one can hope to outperform the market; that, at any given time, market prices accurately reflect the outlook for each stock.
  A. Studies have shown that this is probably true for large investors, such as mutual funds or bank trust departments, but private individuals have the flexibility to buy and sell at will and to buy the stocks of smaller companies, and thus may be able to be an exception to the theory.
  B. Beta is a measure of the volatility of a stock relative to the overall market. It compares the price increase of the stock to the increse in the stock market as a whole. For a diversified portfolio, the average beta of the portfolio will indicate whether the portfolio will be more or less volatile than the stock market averages.

VI. To construct and manage a portfolio having a suitable risk level for you, you should:
  A. Select your risk level or average beta (0.8 to 1.0 for low risk, 1.1 to 1.2 for moderate risk, and 1.3 to 1.5 for high risk).
  B. Diversify by stock category, as discussed in the previous chapter.
  C. Diversify by economic sector (see Table 18-7 in the text) to reduce the business risk in your portfolio.
  D. Buy and hold unless you have reason to believe you can predict bear markets.

VII. There are also ten additional pieces of time-honored Wall Street advice that you should follow.
  A. Investigate before you invest. Do your research before you buy a stock.
  B. Control the emotions that may cause you to buy high and sell low.
  C. Do not buy too many different stocks.
  D. Begin with quality.
  E. Diversify your portfolio. Nobody's crystal ball is perfect.
  F. Don't be afraid to sell and take a capital loss.
  G. Don't sell just for tax-loss write-offs.
  H. Be patient. Major stock market cycles generally last for two to five years.
  I. Reinvest your dividends to maximize your return.
  J. Avoid speculative techniques unless you really know what you're doing.

SELF-TESTING EXERCISES

True-False

____ 1. The procedure by which new issues are sold to the public involves several sales levels.

____ 2. Rights have no monetary value.

____ 3. Memberships in the NYSE are bought and sold.

_____ 4. The OTC market is a negotiated market.

_____ 5. A market in an uptrend is called a bear market.

_____ 6. An order to buy or sell less than 100 shares is called a round lot order.

_____ 7. One may buy both a put and a call in the same stock.

_____ 8. Buying on margin is permitted only in the OTC market.

_____ 9. The theory that recent price moves in a stock are very poor predictors of the next price move is called the beta theory.

_____ 10. Because most inventors have limited funds, it is impossible to diversify portfolios so that they will perform closely to the performance of the market in general.

Completion

1. The market for the original sale of securities by a corporation is called the __________________ market.
2. Organized securities exchanges are regulated by the __________________.
3. Before a company's stock may be traded on an organized stock exchange, it must meet the exchange's __________________ requirements.
4. The largest stock exchange in the world is the __________________.
5. A brokerage house that holds securities of their clients in their safe is said to hold them in __________ __________________.
6. One who invests the same fixed dollar amount in the same stock at regular intervals over a long period of time is said to be using __________________.
7. __________________ is the selling of stock you do not own in the hope of profiting from a decline in the price of that stock.
8. Borrowing from your broker to buy stock is called __________________.
9. The Standard and Poor's stock index is composed of __________________ stocks.
10. An order to buy or sell stock at the best price available at the time of the order is a __________________ order.

Multiple Choice

1. The sale of new issues of stock to the general public is arranged by
   - a. investment bankers
   - b. underwriters
   - c. OTC dealers
   - d. the SEC
   - e. brokers
2. An order made to prevent losses in the event of a decline in stock prices is a
   - a. market order
   - b. stop loss order
   - c. limit order
   - d. short order

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3. To avoid risks, an investor should
   a. select low betas
   b. diversify by type of stock
   c. diversify by economic group
   d. diversify by type of security
   e. (All of the above)

4. Inexperienced investors should avoid
   a. buying on margin
   b. diversification
   c. selling short
   d. (a and b)
   e. (a and c)

5. An option to buy a stock at a specified price is a
   a. warrant
   b. right
   c. call
   d. margin
   e. put

6. In order to dollar cost average, the investor must
   a. invest the same amount each time
   b. buy the same stock
   c. buy regularly
   d. (All of the above)
   e. (None of the above)

7. In investment theory, beta means
   a. random walk theory
   b. selecting stocks by chance
   c. comparisons of volatility
   d. a second choice after alpha

8. A specialist member of the NYSE
   a. is a dealer for himself
   b. is a floor broker
   c. is licensed by NASD
   d. (a and c)
   e. (a and b)

9. Investment bankers are
   a. advisors to companies that issue new stock
   b. marketers of new issues
   c. advisors to investors in the secondary market
   d. (a and c)
   e. (a and b)

10. Rights and warrants have
    a. the same time period to exercise
    b. an exercise price
    c. a dollar value
    d. (a and b)
    e. (b and c)

Cases and Problems

1. Amy bought 100 shares of FIC Corporation at 45 1/8, paying a commission of $87.50. She paid $2,500 in cash and the balance was on margin at an annual rate of 12 percent. One year later, Amy needed funds, so she sold the stock at 47 7/8 from which the selling commission of $92.50 was deducted. During the year she had received $80 in dividends.
   a. What was the percent return on her investment, disregarding inflation and taxes?
   b. What would have been the return had she not used margin?

2. Beth, a receptionist in the offices of five eye specialists, was aware that the new contact lens sold by the AB Medical Technology Company had developed so many problems that the doctors would no longer prescribe it. Over a one-year period, the stock of the company had risen from $20 to $35 per share. Beth reasoned that since the stock had risen in price due to the revolutionary new lens it would decline as the public discovered what she knew. She, therefore, sold 100 shares of that stock short at $35 per share expecting to make a profit. Three months later, the stock was selling at $40 per share after a drop in one day to $32 per share and had shown no signs of falling. She also noticed the doctors were prescribing the lens again.

   a. Excluding in and out commission costs, what would Beth's profit have been had she been able to buy the stock at $20?

   b. What would her loss have been had she bought it back at $40?

   c. What might have caused the unexpected price increase?

   d. Should Beth have used short sales at all?

3. Paul bought 100 shares of Maudlin Gardens, Inc. at $45, and ever since then the company's fortunes went downhill. The stock was now selling for $25 and the outlook was not improving. However, Paul hated to sell for a loss, because his feeling was that you didn't have a real loss until you actually sold it. Do you agree? If Paul sold it now, how much would he lose? If this were a long-term capital loss, and it was the only capital gain or loss Paul had in this year, what would Paul's after-tax loss be if he were in a 30 percent tax bracket? If Parke Place, Inc. looked like a good buy at $25, and Paul wanted to buy it but had no cash, how would you suggest Paul finance the purchase?

4. Louise was 58 years old and planned to retire in four years. She wanted to build a portfolio of stocks that would not only provide income but also possibly increase their dividend payout over time to keep pace with inflation. She did not want to take much risk since she had only four years left to save money from her salary. Her broker recommended his 15 favorite stocks, but she had money to invest in only 10 of them right now. She categorized them by stock group and economic sector as well as she could. Which five would you recommend she *not* buy? Why?

Stock	Dividend Yield	Beta	Stock Group	Economic Sector
Carter Hawley Hale conv. preferred	5.6%	0.9	Mature growth	Distribution
S.S. Kresge	0.9	1.2	Growth	Distribution
Tenneco	5.4	0.9	Mature growth	Energy
Reading & Bates	4.2	1.4	Special situation	Energy
American Electric Power	8.7	0.8	Mature growth	Energy
Syntex	2.4	0.9	Second-tier growth	Health
C.R. Bard	1.8	1.4	Second-tier growth	Health
A.M.F.	5.8	1.3	Special situation	Consumer mfg.
Mohasco	6.0	1.2	Cyclical	Consumer mfg.
I.B.M.	3.6	1.0	Growth	Noncons. mfg.
Digital Equipment	0	1.2	Growth	Noncons. mfg.
Memorex	0	2.0	Special situation	Noncons. Mfg.
Phelps Dodge	6.0	1.0	Cyclical	Mining
American Telephone	6.6	0.8	Mature growth	Services
Sante Fe Industries	5.3	0.9	Mature growth	Transportation

PERSONAL MONEY MANAGEMENT ACTIVITIES

1. Select 20 stocks from the listings in your paper.
2. Do enough research to find the stock's beta and determine its economic sector and stock market group.

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3. Decide on your investment objective.
4. Select the 10 stocks that make the best portfolio for you, doing additional research into the companies' history, future prospects, and P/E ratio pattern, if possible before making the final selection.
5. Keep track of the prices of these stocks for one to three years on a monthly basis.
6. At the end of each year, try to figure out why companies succeeded or failed, why the stocks performed as they did, and whether or not you would continue to hold them or switch into a different stock.
7. Save your money to put your experience and knowledge to work with real cash.

ADDITIONAL ACTIVITIES

1. Go to your school library and read the latest issues of the following publications: *Wall Street Journal, Forbes, Money, Barrons, Kiplinger Newsletter,* and *Business Week*. Decide which of these seem most helpful to a potential investor.
2. Go to the office of a local stockbroker and acquaint yourself with their research facilities, especially the Standard and Poor's stock sheets.

19 · Mutual Funds and Other Professional Management

PERFORMANCE OBJECTIVES

After studying this chapter, you should be able to:

- Explain how to determine when a mutual fund would be a good investment.
- Explain how to select the best group of mutual funds for a particular type of investment.
- Describe how to select the best mutual fund for a given objective.
- Explain the various types of savings, reinvestment, and withdrawal plans that are available with mutual funds and when each would be appropriate to use.
- Explain the general features of other sources of professional securities management—variable annuities, bank trust departments, and investment advisors.

OUTLINE OF THE MAIN IDEAS

I. A mutual fund is a vehicle in which an investment company pools the dollars from many individual investors and invests them in a diversified portfolio of stocks and/or bonds.
    A. *Closed-end mutual funds* issue a fixed number of shares that are subsequently traded among investors at a market price determined by supply and demand on the exchange on which it is traded.
    B. The more common *open-end mutual fund* continuously sells new shares and redeems old shares, upon investor demand, and without limit.
        1. The price per share for such transactions is the *net asset value.* (Assets at current value, less liabilities, with the net value being divided by the number of mutual fund shares then outstanding.)
        2. If open-end fund shares are offered through a broker or salesperson, there is a *load,* or commission, of about 8 percent added to the net asset value for the purpose of determining purchase cost. *No-load funds* do not have such a charge and their investors' needs are handled directly, by mail or by telephone.

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II. Mutual funds are available to meet nearly every portfolio objective.

A. *Common stock funds* may emphasize income, growth, aggressive growth, or some industry specialization.

B. *Bond funds* may invest in corporate, federal, or municipal bonds. *Unit trusts* are corporate or municipal bonds in fixed portfolios.

C. *Mutual fund* funds invest in other mutual funds.

D. *Balanced funds* invest in both stocks and bonds.

E. Other mutual funds invest in money market instruments (see Chapter 16).

III. There are a number of features unique to open-end mutual funds that add to the investor's flexibility.

A. Savings accumulation plans offer a means of regularly investing sums as small as $25 to $50 per month or per quarter, thereby fostering a regular savings habit.

1 Most such plans are purely voluntary.

2. Other plans are contractual and result in some fee penalty should you fail to fulfill the investment program to which you committed yourself.

B. Automatic reinvestment plans enable you to reinvest all dividends and capital gains distributions in additional fund shares.

C. Systematic withdrawal plans enable you to receive regular monthly income from your investment, usually subject to a minimum $10,000 value in fund shares when you start the plan. You may elect to receive:

1. A fixed monthly dollar amount

2. A fixed number of shares

3. An amount equal to a percentage of the asset's growth

4. Dividends and capital gains only

D. Insurance against losses is sometimes available, for a fee of about 6 percent of share value, provided you agree to leave your funds invested at least 10 years and to reinvest all dividends and capital gains.

E. Participants in Keogh or IRA plans can select mutual funds for part or all of their funds.

IV. There are advantages and disadvantages to owning closed-end funds.

A. Dual funds are designed so that one group of shareholders gets only income and the other group gets only capital gains or losses.

B. You may receive higher effective yields with closed-end funds.

C. A closed-end fund avoids becoming too large too quickly.

D. However, closed-end funds do not provide savings accumulation, and reinvestment of dividends requires you to pay a commission.

V. In mutual funds, dividends are taxed at ordinary income tax rates, while capital gains distributions are taxed as long-term gains. Gains from the sale of fund shares are taxed as long-term gains if they are held for at least a year.

A. There are several advantages to investing in mutual funds.

1. Broad diversification

2. Freedom from personal investment management

3. The possibility of developing a regular savings habit

4. Capital gains tax rates are generally favorable.

B. The primary disadvantage is that your investment results are likely to average about 1 percent a year worse than a personally held diversified portfolio because of the fees levied against the fund's assets.

VI. In selecting a mutual fund, select one that is suitable for your goals (e.g., a common stock fund would be too risky for an important goal due in three years), offers a level of risk in their objectives that you are comfortable with, has an experienced group of managers, and, all else being equal, does not charge a front-end load.

VII. There are several other sources of professional security management.

A. A *variable annuity* is a securities investment program offered by a life insurance company.

B. *Bank trust departments* also provide investment management.

C. *Private investment advisory firms* offer individualized management.

D. Employers may provide *profit sharing plans.*

SELF-TESTING EXERCISES

True-False

____ 1. Owners of shares of stock in mutual funds are permitted to share in stock voting rights.

____ 2. Open-end investment companies continually sell and redeem their shares to meet investor demand.

____ 3. The asked price of a load fund is its net asset value.

____ 4. The sales commission should not be the deciding factor in buying a load or no-load fund.

____ 5. The multilayered fee structure of the mutual fund funds tends to argue against owning shares in them.

____ 6. Studies suggest that the trading of low yield for higher yield bonds practiced by bond fund managers greatly increases the return to the investor.

____ 7. Savings accumulation plans offered by mutual funds follow the principle of dollar cost averaging.

____ 8. Closed-end funds offer systematic withdrawal plans.

____ 9. Careful investors in mutual funds will find it worthwhile to insure their mutual fund investment against loss in value.

____ 10. The best long-term capital gains records are to be found in growth funds.

Completion

1. Out of every $20 worth of stock in the New York Stock Exchange, ____________ is held by mutual funds.

2. Investment companies that issue a fixed number of shares that are traded like common stocks are called ____________ companies.

3. The market value of a fund's assets, less its liabilities divided by the number of shares outstanding, is called the ____________ per share.

4. Fixed portfolios of bonds specializing in either corporate or municipals offered in units to investors and priced to yield competitive interest rates are called ____________.

5. Funds that allow the investor to choose to receive income shares or capital gains shares are called ____________ funds.

6. A plan offered by mutual funds enabling the investor to reinvest earnings at no added commission is the ____________ plan.

7. The market price per share of ____________ funds is generally different from the net asset value per share.

8. Mutual funds that invest in fixed proportions of both stocks and bonds are ____________ funds.

9. The objectives of a mutual fund are outlined in its ____________.

10. A ____________ is a securities investment program offered by a life insurance company.

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Multiple Choice

1. The voting rights of shares owned by mutual funds belong to

   a. shareholders of the fund
   b. the commissioned broker
   c. the fund management
   d. the board of directors
   e. (All of the above)

2. The cost of buying and selling shares in a closed-end investment company is the

   a. net asset value
   b. broker's commission
   c. bid price
   d. asked price
   e. load

3. The difference between the bid and asked price of a mutual fund is the

   a. broker's commission
   b. sales charge
   c. load
   d. (b and c)

4. Mutual funds offer the principle of dollar cost averaging through

   a. systematic withdrawal plans
   b. automatic reinvestment plans
   c. closed-end mutual funds
   d. savings accumulation plans
   e. (All of the above)

5. Based on an average return of 7 percent, if you want your mutual fund systematic withdrawal plan to yield fixed regular payments for at least 10 years, you should withdraw per $1,000 investment no more than how much a year?

   a. $95
   b. $105
   c. $140
   d. $160
   e. $175

6. The automatic reinvestment plan is advantageous for the investor because it

   a. has no extra commission
   b. permits dollar cost averaging
   c. permits compounding
   d. (a and c)
   e. (a and b)

7. Under which of these systematic withdrawal plans will your fund eventually be depleted?

   a. Fixed dollar amount
   b. Fixed number of shares
   c. Percentage of the asset's growth
   d. Dividends and capital gains

8. In the 15-year period ending with 1977, the average growth fund, assuming all dividends were reinvested, rose at a compound rate of

   a. 4.5%
   b. 5.2%
   c. 7.2%
   d. 9%
   e. 15.3%

9. In choosing a mutual fund, which of these is the LEAST important consideration?

   a. Objectives of the fund
   b. Past performance
   c. Part of a family of funds
   d. Load or no-load

Cases and Problems

1. Tammy invested $10,000 in the XYZ diversified common stock fund 10 years ago. At that time, the fund's shares were quoted at $9.39 bid and $10.14 asked. The salesperson assured her that the fund had performed well over the past 10 years and that the 8 percent commission was unimportant in a good performance fund. Ten years later, her fund holdings had increased to 2,010.45 shares quoted at $14.10 bid and $15.23 asked.
   a. How many shares did Tammy receive for her $10,000?
   b. What was the dollar value of her holdings after the 10 years?
   c. What was the annual compound rate of return on the fund?
   d. Was this a good return if the 10-year period was from 1969–79?
   e. If she decides to use a systematic withdrawal plan, what annual amount may she withdraw over a 20-year period based on an expected performance of 7 percent?
2. The BB&K open-end mutual fund had the following balance sheet at the close of business one day.

Market value of common stocks	$26,000,000
Market value of bonds	3,200,000
Cash in bank	1,000,000
Total assets	$30,200,000
Fees due management	$ 200,000
Total liabilities	$ 200,000

   What would be the redemption value of each share if there were 2,000,000 shares outstanding that day? What would the purchase price be if the fund added an 8 percent load to its net asset value per share?

3. Fifteen years ago, Irene invested $4,000 in a balanced fund, had all dividends and capital gains automatically reinvested, and now has shares with a total value of $12,800. This represents most of her liquid assets.
   a. What has been her average annual compound return?
   b. Would she have been nearly as well off in a savings and loan long-term certificate?
   c. Irene needs $2,000 a year beginning next year, in addition to her salary income, to help send her daughter to college for four years. What should she do?
4. Henry R. Katz has $2,000 he can afford to risk and wants to try to maximize his gain over the next six years. Which of the following funds would you recommend based on the data shown?

Objective		Total Size of Fund	Type of Fund
Fund A	Balanced	$100,000,000	Stock and bond
Fund B	Growth	30,000,000	Common stock
Fund C	Speculative	350,000,000	Common stock
Fund D	Growth	40,000,000	Dual fund capital shares
Fund E	Income	90,000,000	Common stock

PERSONAL MONEY MANAGEMENT ACTIVITIES

1. Determine your personal objectives in investing, taking into consideration your present circumstances.
2. Using the list of funds in the text (pp. 472–73), research at least three funds that match your objectives, noting their performance over the past three decades.
3. Check the performance of two no-load and two load funds that match your investment objectives. Use the August issue of *Forbes*, *Johnson's Investment Company Charts*, and *Investment Companies* (Wiesenberger).

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20 · Real Estate

PERFORMANCE OBJECTIVES

After studying this chapter, you should be able to:

- Explain when and how to invest in first and second mortgages (or deeds of trust).
- Explain when a real estate investment trust (REIT) would be a wise investment.
- Explain when a real estate limited partnership would be an appropriate investment.
- Explain how to discriminate between potentially successful and potentially poor real estate limited partnerships.

OUTLINE OF THE MAIN IDEAS

I. Mortgages and deeds of trust offer an alternative to time deposits, bonds, and insurance as media for lending money.
  A. The collateral on such loans is real property on which you could foreclose if the borrower defaulted on the payments.
    1. First mortgages (or first deeds of trust) have the first right to recoup their principal, interest, and legal expenses upon foreclosure and sale. They are usually issued by banks and savings and loan associations but may be available to individuals through *mortgage pools*.
    2. Second mortgages have rights to the next amount, which may or may not be sufficient to cover all costs.
      a. Although there are high interest yields and regular income from seconds, the investor has no inflation hedge, poor liquidity, and the potential risk of lengthy and uncertain foreclosure proceedings.
      b. To invest in second deeds of trust, you should engage the services of a reputable, experienced loan broker who will make and service your investments. In your loan, you should look for:
        (1) Request for notices of default and sale
        (2) Acceleration clauses
        (3) Penalty on late payments
        (4) Prepayment penalties

II. Real estate ownership provides one of the best inflation hedges.
  A. The most common method of real estate investment is to own a rental house, duplex, or triplex.
    1. Because of their popular appeal, such investments are high priced relative to rents.
    2. A simple, but realistic, analysis of such investments shows that you typically can expect break-even or negative cash income and some modest income tax benefits. Thus, obtaining a reasonable return on investment requires price appreciation, which is not guaranteed, and which has historically not always occurred.
  B. The real estate investment trust (REIT) is an unincorporated association that invests in mortgages (a mortgage trust) or real property (an equity trust). At least 90 percent of its earnings must be paid out to the shareholders, and it has other restrictions. There may be tax advantages for you in owning such shares.
    1. Short-term mortgage REITs acquired a bad reputation in the mid-70s because most of them invested in high-risk construction and other mortgages using money borrowed from banks. The overbuilt real estate markets and resulting vacancy problems caused substantial losses and even bankruptcy for many of the short-term mortgage trusts.
    2. The equity REITs offer a true method of investing in inflation-hedged real estate income properties. The few such trusts that exist do have a generally good investment record.
  C. A real estate investment company is similar to a REIT except that it must pay a corporate income tax, and thus you can be taxed twice. However, you can benefit from its capital growth.
  D. Limited partnerships (syndicates) offer a means of pooling the dollars of small investors ($2,500 or more) for the purchase of large income properties (often $1,000,000 or more) whose economies of scale offer potentially positive cash income, even after paying the syndicator's management fees. There are two forms of limited partnership investments: single property and blind pool
    1. The total return on a real estate syndicate investment is composed of four components.
      a. Cash flow distribution
      b. Equity buildup (due to principal payments on the mortgage)
      c. Price appreciation
      d. Tax shelter benefits (primarily due to depreciation deductions)
    2. There are four potential risks:
      a. Paying too much for the property (check the *gross income multiplier* and the *capitalization rates*)
      b. High level of vacancy
      c. IRS challenges to some of the tax deductions
      d. The general partner going bankrupt
    3. There are advantages to syndicate investments.
      a. High total yield
      b. No management required of the investor
      c. Economies of scale
    4. There are also disadvantages.
      a. Long periods before investments are realized
      b. Relatively high costs involved
      c. Illiquidity
      d. High risk
      e. You must meet financial qualifications.
    5. Before making a syndicate investment, check it against the fourteen points for evaluation listed in the text (pages 492–95) and if possible, ask an unbiased, informed source (an investment advisor, attorney, etc.) for his or her opinion.

SELF-TESTING EXERCISES

True-False

_____ 1. First mortgages and first deeds of trust have different purposes in securing loans on real property.

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____ 2. Legal expenses involved in foreclosure and sale usually run 15 to 20 percent of the sale price of the property.

____ 3. First mortgages are sometimes available to investors through mortgage pool shares offered by banks.

____ 4. Returns on second mortgages are several percentage points above the rates on firsts.

____ 5. A REIT that invests in real property is called a mortgage trust.

____ 6. Mortgage trusts limit their investments to first and second mortgages.

____ 7. Risk and returns are higher on short-term than on long-term mortgage trusts.

____ 8. The single-property syndicator purchases an option to buy a single property and then offers investment shares for the amounts needed to complete the investment.

____ 9. The minimum acceptable capitalization rate for income-producing property should be at least equal to the current long-term mortgage interest rate.

____ 10. Government-subsidized projects are good opportunities for syndicate investors because they offer tax losses and high cash flows.

Completion

1. A ____________________ is usually issued to finance that part of the purchase price on a piece of property that is not covered by the down payment and the first mortgage.
2. The primary source of seconds for the investor is the ____________________.
3. A ____________________ requires second and first lenders to let each other know when a loan is in default.
4. The ____________________ clause prevents the borrower from assigning his debt to any other person without permission of the lender.
5. A ____________________ is an unincorporated association that invests in mortgages or real property.
6. Similar to a trust, except that it must pay a corporate income tax, is the ____________________.
7. A group of people (partnership) joined together under one management (general partner) to buy and manage property is a(n) ____________________.
8. That part of the total yield on a syndicate investment arising from distribution of the cash income from the syndicate property is the ____________________.
9. The total price paid for a property divided by the projected gross income from the property is called the ____________________.
10. The rate derived by dividing the net operating income (after expenses but before depreciation and loan payments) by the total purchase price of the property is the ____________________.

Multiple Choice

1. In normal times, foreclosures generally occur in about what percentage of all mortgage loans?

   a. 1-3%
   b. 3-5%
   c. 5-7%
   d. 7-9%
   e. 9-11%

2. The main benefit to the typical owner of a duplex or triplex apartment is
    a. high yield
    b. high cash flow
    c. tax shelter
    d. price appreciation potential
    e. deflation hedge

3. Advantages of second trust deeds are
    a. high yields
    b. inflation protection
    c. safety
    d. liquidity
    e. tax shelter

4. The poor reputation of mortgage (especially construction mortgage) REITs is due to
    a. heavy losses from risky loans made with borrowed money
    b. excessive fees charged by the manager
    c. bad luck
    d. the tax laws in the Trust Act of 1960

5. A syndicate in which investors buy shares before properties are acquired is called a(n)
    a. specified asset partnership
    b. blind pool
    c. deaf fund
    d. general partnership
    e. equity REIT

6. Which is NOT a potential benefit from owning real property, whether on your own or through a syndicate?
    a. Cash income
    b. Equity buildup
    c. Price appreciation
    d. Income tax advantages
    e. Low risk

7. Equity buildup is a return to the investor created by
    a. mortgage reduction
    b. tax savings
    c. cash flow distribution
    d. an interest-only second mortgage
    e. (All of the above)

8. A potential risk to a syndicate investor is
    a. selling the property for less than the purchase price
    b. loss of tax benefits due to Congressional or IRS actions
    c. a general partner who fails to stay in business
    d. insufficient rental income due to local economic conditions
    e. (All of the above)

9. In evaluating a syndication, high priority should NOT be placed on the
    a. syndicator's projected appreciation potential for the property
    b. syndicator's record
    c. reasonableness of the fees
    d. adequacy of initial and operating cash reserves

10. A blind pool offers advantages over a single-property syndicate because
    a. the properties can be evaluated before investing
    b. property diversification reduces your risk
    c. you get better tax shelter benefits
    d. you don't need to be as discriminating in your investment selection

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Cases and Problems

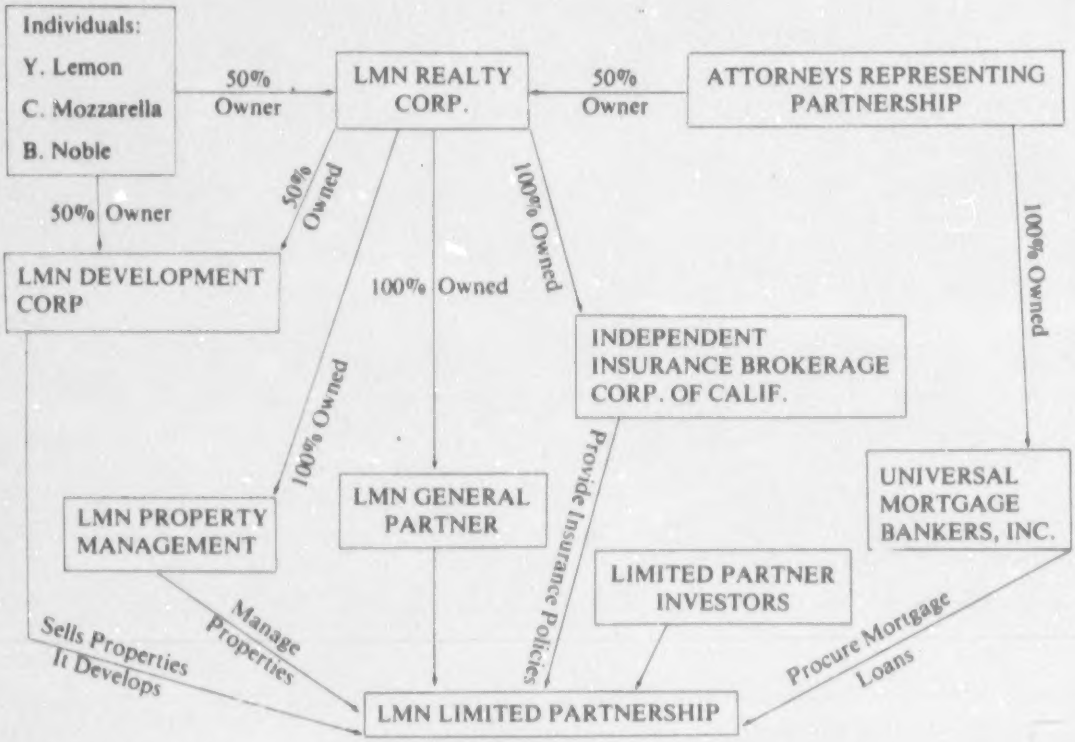
1. Tony bought a duplex for $50,400 and received rents of $350 per month per apartment. He paid $10,080 down and borrowed the balance on a 10 percent, 20-year mortgage, the annual payments of which were $4,736. Other annual expenses were insurance $260, maintenance $500, taxes $2,500. Assume that land is 20 percent of cost, depreciation is for 30 years, and Tony is in a 30 percent tax bracket (see Figure 20-1 in the text).

   a. What was Tony's annual cash flow?

   b. What were Tony's first full year tax benefits?

   c. What was Tony's first year return on his investment?

2. The following organization chart appears in a blind pool limited partnership offering circular, along with the claim that the partnership should be successful because the general partner can control all phases of the partnership activities. (Similar charts *have* been found by the authors while investigating possible investments.) What are the potential conflicts of interest? Would you invest in this partnership?


Individuals:
Y. Lemon
C. Mozzarella
B. Noble
50% Owner
LMN REALTY CORP.
50% Owner
ATTORNEYS REPRESENTING PARTNERSHIP
50% Owner
50% Owned
100% Owned
100% Owned
100% Owned
LMN DEVELOPMENT CORP
INDEPENDENT INSURANCE BROKERAGE CORP. OF CALIF.
100% Owned
UNIVERSAL MORTGAGE BANKERS, INC.
LMN PROPERTY MANAGEMENT
LMN GENERAL PARTNER
Provide Insurance Policies
LIMITED PARTNER INVESTORS
Sells Properties It Develops
Manage Properties
Procure Mortgage Loans
LMN LIMITED PARTNERSHIP

3. Ms. O. Pride wants to own her own investment property and is considering a fourplex firmly priced at what the broker says is the typical "100 times the monthly rents," which happens to be $1,400 ($350 each unit). Also, since Ms. Pride does not want to be bothered with the routine management duties, the broker has offered to have his affiliated management firm do this for the normal fee of 5 percent of the gross collected rents (including the $300 average total forfeited cleaning deposits each year). The local savings and loan will provide a $110,000 amortized loan at 8½%, with monthly payments of $847. Property taxes are $3,000; water, garbage, and gardening cost $180 per month; insurance runs $400; and the record shows that these well-located units are vacant only 3 percent of the time. Ms. Pride's experienced real estate friend also tells her she ought to allow an average of $50 per unit per

month as a reserve for major repairs such as exterior painting, re-roofing, and replacing water heaters. Normal maintenance (interior painting, clean-up, electrical, plumbing) should run about $200 per unit per year if she's careful with her money.

a. What level of annual cash income can Ms. Pride expect after she sets aside her major repair reserves in the bank?

b. What is this amount as a percentage of her down payment?

c. How much must the property appreciate next year for her to break even? (Ignore broker's commission, mortgage reduction, and tax benefits in this calculation.)

PERSONAL MONEY MANAGEMENT ACTIVITIES

1. Call three or four mortgage loan brokers and ask about yields, liquidity, management records of these companies, and the amounts that may be invested.
2. Ask a local broker to obtain some prospectuses of REITs and check the Standard and Poor's *Stock Guide* for their earnings/share for the past five years, their P/E ratios, their price and earnings trend.
3. Ask a local realtor or the local realty board for the names and phone numbers of two or three syndicate general managers, and investigate their offerings.

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21 · Retirement

PERFORMANCE OBJECTIVES

After studying this chapter, you should be able to:

- Explain the importance of planning for the financial needs of retirement.
- Plan for your retirement needs and goals.
- Deal with inflation's effect on retirement financial resources.
- Describe the various types of public and private retirement programs.
- Develop strategies to supplement existing retirement programs.

OUTLINE OF THE MAIN IDEAS

I. Advance financial planning is your best hope that you will be able to afford a comfortable retirement.
   A. To plan effectively, try to visualize accurately what your lifestyle will be (e.g., no dependents, smaller home, etc.) when you plan to retire.
   B. Establish financial goals both for basic necessities and those considerations such as travel and hobbies that can transform retirement into an enjoyable experience.

II. To compute your total retirement needs, you should refer to procedures in the text discussed on pages 503–8.

III. There are several common sources of retirement income.
   A. Social Security provides retirement benefits generally beginning at age 65.
      1. Full benefits are available only when you earn less than a certain amount per month during retirement. For people 72 and older, this condition does not apply.
      2. Recent dramatic increases in benefits levels legislated by Congress, inflation, and the declining birth rate have brought the long-term financial viability of this program into question.

B. Pension funds are available to employees of most companies and governmental agencies (including the armed services).
   1. Financing of benefits can either be in advance or as benefits become due.
   2. Contributions to the plan may be made either totally by the sponsoring organization, partially (required) by the employees, or partially (voluntary) by the employees.
   3. Eligibility for membership in a pension fund is usually based on a minimum age (e.g., 25) and/or a minimum period of employment. There may also be requirements for membership of a certain period of years in the retirement program before eligibility for benefits is granted.
   4. Retirement dates are usually specified (June 1 of the year you reach 65, for example). *Vesting* means you can receive retirement benefits upon reaching retirement age even if you decide to prematurely leave the organization (e.g., to seek employment elsewhere).
   5. Pension benefits can be paid in different forms, depending on your needs.
   6. Persons receiving retirement benefits enjoy certain tax benefits.
   7. Deferred profit sharing plans are often used as a substitute or supplement to a pension plan.

C. The Employees Retirement Income Security Act of 1974 (ERISA) set minimum levels of acceptability for private pension and profit sharing plans.
   1. "Keogh" retirement accounts enable *self-employed individuals* to set aside up to $7,500 of earned income each year, tax-free, toward retirement.
   2. Individual retirement accounts (IRAs) were established by ERISA to enable *employees* not eligible for other retirement plans to set aside up to $1,500 of income each year, tax-free, toward retirement.

D. There is a tax break for people selling their home if they are 55 or older.

E. Individual investment strategies should stress current income. There are several investment vehicles that offer regular income.
   1. U.S. savings bonds, corporate bonds, certificates of deposit, and annuities are the safest.
   2. Common stocks, mutual funds, and income-producing real estate are the best protection against inflation.

IV. To determine how adequately the resources discussed above will provide for your retirement needs, you should refer to the procedure in the text on pages 515–18.

SELF-TESTING EXERCISES

True-False

____ 1. Retirement is a type IV goal.

____ 2. One should begin planning and investing for retirement at least 20 years before one retires.

____ 3. In planning retirement, one should ignore all other goals.

____ 4. In planning retirement needs, an estimate of the number of years of retirement is necessary.

____ 5. Social Security retirement benefits may be received in full between ages 65 and 72 provided earnings are below $4,500 per year.

____ 6. Social Security benefits provide adequate financial security for persons 65 and older.

____ 7. Pension funds managed by insurance companies are used to buy either cash value life insurance or deferred annuities.

____ 8. The most common form of pension fund management is an insurance company.

____ 9. The maximum waiting period for eligibility for admission to a retirement program is one full year for employees 25 or older.

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Completion

1. The 1962 act that allows self-employed persons to set up their own retirement plans with certain tax benefits is called the ____________________.
2. The most common option in receiving pension payments is a ____________________.
3. A company that sets aside a small fixed percentage of profits as a supplement to or a substitute for a pension fund is offering a ____________________ plan.
4. Persons who have earned income from full- or part-time work and who do not have the opportunity to join a retirement program may have an ____________________.
5. Under both ____________________ and ____________________ plans, the contributions to pensions are deducted from gross income and are not subject to taxes in the year of the contribution.
6. The term ____________________ refers to the amount of retirement benefits to which you become entitled under a pension plan due to your length of time in the plan.
7. Up to certain limits, taxpayers 65 and older can receive an investment credit for ____________________ percent of taxable income.
8. The ____________________ known as ERISA sets minimum levels of acceptability for private pension plans.
9. ____________________ benefits and pensions help fill your retirement needs.
10. According to a report of the Special Committee on Aging, ____________________ percent of the nation's retired people have incomes at or near the poverty level.

Multiple Choice

1. About how long in advance should you begin planning for retirement?
   - a. 50 years
   - b. 20 years
   - c. 7 years
   - d. 5 years
2. Which of the following may lead to serious difficulties for retired people?
   - a. Fixed income combined with inflation
   - b. Early retirement and longer life expectancy at retirement
   - c. Customary high standard of living
   - d. (All of the above)
3. In planning for retirement, the *most* important considerations are
   - a. hobbies and leisure activities
   - b. travel
   - c. food, shelter, clothing, health, etc.
   - d. (All of the above)
   - e. (None of the above)
4. Social Security benefits may include which of the following?
   - a. Medicare
   - b. Survivor's benefits
   - c. Retirement benefits
   - d. Disability payments
   - e. (All of the above)
5. Which of the following may interest you if you are self-employed?
   - a. ERISA
   - b. IRA
   - c. SEC
   - d. Keogh

6. Upon retirement, which of the following might be worth considering? (Assume average to low income.)

   a. Buying larger home
   b. Selling home
   c. (All of the above)
   d. (None of the above)

7. Which of the following should be considered in calculating total money needed for retirement?

   a. Lump sum cost of one-time goals
   b. Recurrent extra expenses
   c. Inflation's effect on money needed
   d. (All of the above)

8. If you were most concerned with obtaining a hedge against inflation, which of the following would you choose?

   a. Savings bonds
   b. Corporate bonds
   c. Income-producing real estate
   d. (None of the above)

9. Social Security was originally planned to be

   a. the main source of retirement income
   b. only applicable to military retirees
   c. a supplemental source of retirement income
   d. applicable only to disabled persons

Cases and Problems

1. Noel and Mia are both 50 and plan to retire when they reach 65. At that time, they will have no dependents and estimate that their basic living expenses will cost $9,000 in current dollars. In addition, they expect that certain hobbies and interests during retirement will cost $2,000 annually, also in current dollars. They anticipate no large one-time costs.

   a. Assuming a 15-year retirement period and a 3 percent annual inflation rate, what will be their total inflated living expenses at retirement?

   b. What is the amount assuming a 20-year retirement period?

   c. What is the amount assuming 20 years and a 4 percent annual inflation rate?

2. Noel and Mia will each receive $450 per month in retirement benefits at age 65 at current benefit levels. Their combined monthly pensions will be fixed at $700. What will be their total estimated retirement income from Social Security and pensions for each of the three conditions cited in case problem 1 above?

PERSONAL MONEY MANAGEMENT ACTIVITIES

1. If you have retired relatives or close friends, talk with them tactfully and seek their advice about:

   a. the time to begin serious retirement planning
   b. whether their pension benefits combined with Social Security are adequate
   c. whether their lifestyle had to change to cope with inflation
   d. what, if any, mistakes they made that you might avoid

2. Visit your local Social Security office to determine documents needed, benefits you or your dependents might expect in the event of disability or death, and whether the future will bring retirement payments still tied to the consumer price index.

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NAME(S) ____________________

DATE ____________________

RETIREMENT LIVING EXPENSE NEEDS

1 *Age at Retirement*

Husband ________

Wife ________

2 *Basic Living Expenses*

	Month	*Year*
Housing		
Utilities		
Repairs		
Insurance		
Taxes		
Other ____________		
Rent or mortgage payments		
Food		
Clothing, personal care		
Him		
Her		
Gifts, contributions		
Transportation		
Gas		
Repairs		
Licenses		
Insurance		
Auto payments or purchase		
Medical		
Doctor		
Dentist		
Medicines		
Insurance		
Taxes (personal income)		
TOTAL		
3 *Recurrent Extra Expenses*		
Gardening		
Travel		
Other ____________		
TOTAL		

4 *Total Annual Living Expenses* ________

5 *Expected Number of Years of Retirement* ________

6 *Total Living Expenses during Retirement* ________

7 *One-Time Costs* ________

8 *Total Funds Needed at Retirement* ________

9 *Years to Retirement* ________

10 *Inflation Factor* ________

11 *Total Inflated Living Expenses at Retirement* ________

NAME(S) ______________________________

DATE ______________________________

RETIREMENT INVESTMENT NEEDS

1 *Age at Retirement*
    Husband ______
    Wife ______

2 *Monthly Social Security Benefits*
    Worker at 65 ______
    Spouse at 65 ______
    TOTAL ______

3 *Annual Income from Social Security* ______

4 *Inflation Factor* ______

5 *Inflated Annual Income from Social Security* ______

6 *Annual Pension Benefits*
    Worker ______
    Spouse ______
    TOTAL ______

7 *Total Estimated Annual Income from Social Security and Pension* ______

8 *Expected Number of Years of Retirement* ______

9 *Total Estimated Retirement Income from Social Security and Pension* ______

10 *Total Inflated Living Expenses* ______

11 *Investment Needed at Retirement* ______

12 *Profit from Sale of Home* (after taxes and selling costs) ______
    Current market value of home ______
    Inflation factor ______
    Market value at retirement ______

13 *Adjusted Total Investment Needed at Retirement* ______

14 *Investment Strategy Needed*
    Amount to be invested yearly ______
    After-tax interest ______

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22 · Transferring Your Estate

PERFORMANCE OBJECTIVES

After studying this chapter, you should be able to:

- Define the various types of ownership rights.
- Explain what a will can accomplish.
- Explain how the probate process works.
- Explain the ways of partially bypassing the probate process.
- Explain the procedure for computing federal gift taxes and federal estate taxes.
- Describe the appropriate use of trusts, gifts, and joint ownership interests to reduce estate transfer costs.

OUTLINE OF THE MAIN IDEAS

I. Estate transfer considerations are important to assure a smooth transfer of your assets and the responsibility for their management to your heirs.

II. There are many legal aspects of estate transfer. Your attorney can best assure that you take appropriate advantage of these considerations. The most common means of estate transfer is the will.
   A. There are two "sources" of property rights: separate property (earned by an individual prior to marriage or inherited personally) and community property (earned by the husband and/or wife during the marriage).
   B. There are three basic forms of title.
      1. Separate property
      2. Community property
      3. Joint ownership
         a. In *joint tenancy* two or more owners hold a percentage of the property. It may be willed.
         b. In *tenancy by the entirety,* available only to husbands and wives, property may not be disposed of without the permission of both.

c. In *tenancy in common* there may be two or more owners, each of whom may dispose of the property. It passes to one's heirs.

C. Your will can be used to dispose of property to heirs, designate your executor, create trusts, and designate guardians for children. There are five elements to a will.
  1. Opening recitation
  2. Disposition clauses
  3. Administration clauses
  4. Testamonium clause
  5. Attestation clause

D. The "letter of last instructions" is an appropriate place to put your wishes about the details of your burial, location of your personal records, etc.

E. The "probate process" determines the legality and the authenticity of your will. Your will must be in writing, signed by you, and witnessed.

F. Your executor will have several duties during the probate process.
  1. Assembling records of all your assets
  2. Safeguarding and managing your financial interests
  3. Resolving creditor's claims
  4. Paying estate, inheritance, and income taxes for your estate
  5. Distributing your estate to your heirs

G. Gifts, certain forms of joint ownership, and trusts can be used to partially bypass the probate process.
  1. The advantage of joint ownership is that you can avoid probate; the disadvantages are that you lack complete control of the property so that it may be difficult to sell, that joint ownership does not offer flexibility, and that in some states such property may be seized to satisfy creditors.
  2. There are two primary forms of trusts.
    a. Living trusts are put into effect during your lifetime. There are three types:
      (1) Revocable
      (2) Irrevocable
      (3) Reversionary
    b. Testamentary trusts are put into effect by your will.

H. "Intestacy" occurs when you die without having a valid will. Thus, your estate is distributed by guidelines established by state law.

III. There are also many important financial aspects of estate transfer. There are two costs to be concerned with: probate and administrative fees (court, appraisal, accounting, legal costs, etc., incurred while an estate is being settled), and taxes.

A. The federal gift tax is levied on the transfer of property as a gift from one living individual to another.
  1. You may give away up to $3,000 each year tax free to as many people as you like.
  2. The "marital deduction" allows you to give, while you are alive, certain amounts of your separate property to your spouse, tax free.
  3. Each taxable gift is taxed at a cumulatively higher bracket.
  4. The Tax Reform Act of 1976 instituted certain one-time credits against gift taxes.

B. The federal estate tax is computed as if your estate were one last gift.
  1. Your gross estate is your ownership interest in all your assets.
  2. From this amount certain "ordinary and charitable" deductions (funeral expenses, administrative expenses, claims against your estate, uninsured losses) may be taken.
  3. The marital deduction allows you to pass part of your estate to your surviving spouse tax free in certain instances.
  4. Your taxable estate is net of all appropriate deductions. The tentative estate tax is calculated on this amount. Under most circumstances, a credit against this tax is available due to the Tax Reform Act of 1976. The remaining tax due, if any, is the net estate tax.

C. Giving assets away before death may cause the income from those assets to be taxed less (if the recipient's income tax bracket is lower than yours).

D. Joint ownership of certain assets creates certain tax problems and financial opportunities and should be pursued only with the assistance of good legal counsel.

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E. Trusts offer two possible financial advantages in certain situations.
   1. You could place assets in a reversionary trust to have the income taxed to beneficiaries in lower income tax brackets.
   2. You could also divest appreciating assets away from your estate with an irrevocable trust that, if left in your ownership, would ultimately increase the size of your estate and your estate taxes.

SELF-TESTING EXERCISES

True-False

_____ 1. The form in which you hold property must parallel its source.

_____ 2. In a will the attestation clause contains your signature of approval.

_____ 3. A will should state whether inheritance taxes should be paid out of the estate or by the beneficiary.

_____ 4. It is generally advisable in a will to appoint a personal friend and a trust company as co-executors.

_____ 5. The best witnesses to your will are members of your family.

_____ 6. Property held as tenancy in common is included in the decedent's estate and must pass through probate.

_____ 7. Federal gift and estate taxes are computed independently of each other except for certain gifts made within three years of death.

_____ 8. All charitable contributions, no matter how large, are deductible from total gifts in the computation of gift tax.

_____ 9. In estate planning, practically anyone can do it and save large legal fees.

_____ 10. The Tax Reform Act of 1976 unified gift and estate taxes into a single system for taxing all transfers from one person to another during lifetime or at death.

Completion

1. Property earned by a husband and wife during their marriage, regardless of which is the breadwinner, is _______________________.
2. A legal document that expresses your desires in the disposition of your estate upon death is a _______________________.
3. The person designated in a will to dispose of your estate is called the _______________________.
4. A clause in a will which states that beneficiaries must survive the deceased by a certain number of days is called a _______________________ clause.
5. Persons appointed to receive the assets of a trust upon its termination are _______________________.
6. The _______________________ process is the approval of the authenticity and legality of a will by a state court.
7. A trust set up in the trustor's will that does not go into effect until his or her death is a _______________________ trust.

8. A trust agreement that can never be canceled once put into effect is an ____________ trust.

9. One who dies without a will is said to have died ____________.

10. The ____________ permits you to deduct from your total gifts a portion of your separate property given to your spouse.

Multiple Choice

1. A title to property available only to husbands and wives is

a. joint tenancy	c. tenancy in general
b. tenancy by the entirety	d. tenancy in common

2. The clause in a will that indicates how its instructions are to be carried out is the

a. disposition clause	c. administrative clause
b. attestation clause	d. testamonium clause

3. A legal instrument that enables you to revise your will without completely rewriting it is a

a. codicil	c. reversion
b. revision	d. rider

4. To partially bypass probate, you may use

a. gifts	c. trusts
b. joint ownership	d. (All of the above)

5. The annual exclusion from the federal gift tax per recipient is the first

a. $10,000	d. $4,500
b. $8,000	e. $3,000
c. $5,000	

6. Which of these is NOT a trust?

a. Irrevocable	d. Revocable
b. Intestate	e. Reversionary
c. Living	

7. The unified tax credit that may be applied against the gift tax after 1980 is

a. $47,000	d. $30,000
b. $42,500	e. $6,000
c. $34,000	

8. The estate tax return must be filed within nine months of the date of death after 1980 if the decedent's gross estate exceeds

a. $175,000	d. $134,000
b. $161,000	e. $120,000
c. $147,000	

9. If you die without a will, your estate

a. reverts to your spouse	d. escheats to the state
b. reverts to your children	e. is settled by laws of the state of domicile
c. is settled by federal statute	

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10. To be reversionary, a trust must be irrevocable for

a. 15 years
b. over 5 years
c. over 10 years
d. life of the trustor
e. life of the beneficiary

Cases and Problems

1. Mr. Green dies in 1980. His estate, left to his wife, consists of the following assets, debts and expenses: home $85,000, savings $8,000, stocks $130,000, corporate bonds $50,000, real estate $100,000, personal property $40,000, home mortgage $30,000, debts $7,000. The following information is also available: funeral expenses $3,000, executor's expenses $18,000, charitable donations $9,000. In 1978 he gave his wife $120,000 of his separate property and in 1979 he and his wife made a gift of $15,000 to their son.

   a. Determine the taxable estate of Mr. Green.

   b. Using Table 22-1, determine the estate tax of Mr. Green.

2. In 1977, J. P. Moneymum gave $100,000 of his separate property to his lovely wife, Ashleigh. What was the amount of this gift that was subject to the marital deduction? In 1979, he generously gave her another $120,000 of his separate property. What, if any, was the marital deduction available on this amount?

3. Derive the taxable estate from the following information.

Savings	$ 4,000
Home	70,000
Stocks	25,000
Personal property	15,000
Life insurance proceeds	50,000
Funeral expenses	1,000
Home mortgage	15,000
Executor's expenses	3,000
Charitable contribution	5,000

(The marital deduction is not considered here.)

PERSONAL MONEY MANAGEMENT ACTIVITIES

1. Refer to your latest balance sheet to determine your present estate and consider the persons you would like to receive it upon your death. Also consider what you must do now to reduce probate fees and estate taxes and whether your estate is large enough to warrant the expense of expert legal and tax advice.

Answers to the Exercises

CHAPTER 1 INTRODUCTION

True-False

1. F
2. T
3. F
4. T
5. F
6. F
7. F
8. T
9. T
10. T

Completion

1. emotions, values, advertising
2. fear, greed
3. demographic, geographic, psychographic
4. personal, financial
5. consumer price index

Multiple Choice

1. d
2. b
3. c
4. c
5. e

Cases and Problems

1. If Maria believes that quality costs money and she wants a bag that will last a long time, or if her friends sneer at vinyl or at discount stores, she'll probably buy one of the leather bags. If she feels that handbags go in and out of style quickly and the $18 one strikes her fancy, she'll probably buy it. There are many influences on spending decisions.

2.

Goal \ Year	1	2	3	4	5	6	7	8
New car		$6,800						
Vacation	$750							
College education								$5,000
Home down payment				$5,500				
Music lessons	$500	$500						
Total	$1,250	$7,300		$5,500				$5,000

3. a. Although Elton makes enough to support his family, he seems to be a poor financial manager. His debts may have arisen from (1) excessive use of credit cards, (2) using credit to pay for consumables such as vacations, (3) improper purchases of insurance coverage, (4) inadequate tax planning, (5) unwise investment speculation, and other bad financial management.

   b. The course in money management would cause Elton (1) to know his financial position at all times, (2) to budget his expenses, (3) to buy insurance properly, (4) to use credit wisely, and (5) to avoid speculation in investing.

CHAPTER 2 YOUR CAREER AND INCOME

True-False	**Completion**	**Multiple Choice**
1. T	1. more	1. c
2. F	2. high school dropouts	2. d
3. F	3. know yourself	3. b
4. T	4. résumé, cover letter	4. e
5. F	5. résumé	5. c
6. F		6. d
7. T		
8. T		
9. T		
10. T		

Cases and Problems

1. a. Defer the decision a year while he learns more about himself and the alternatives.

   b. Take general education courses he will need for his degree while continuing with geology and economics.

   c. He should get to know himself better through interviews with counselors and teachers, by taking aptitude and interest tests, and by reflecting on his past experiences.

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2. a. Either Carl or Dana could change careers now because, as a double income family, they are more independent financially than they would be otherwise.

   b. Although the decision should not be based on purely financial grounds (Carl's increase in salary), the future financial effects of the job change should be considered. Dana may be able to get a similar job based on her education and work experience. However, the family might experience the shock of leaving family, friends, schoolmates.

CHAPTER 3 YOUR FINANCIAL STARTING POINT

True-False	Completion	Multiple Choice
1. T	1. personal information	1. b
2. F	2. safe-deposit box	2. d
3. T	3. balance sheet	3. d
4. F	4. net loss	4. a
5. T	5. liability (or debt)	5. d
6. F	6. assets	6. e
7. T	7. income statement	7. c
8. T	8. net worth	
9. F	9. increases	
10. T	10. monetary	

Cases and Problems

1. a. Income Statement for 1979

Revenues		$30,000
Expenses		
Taxes	$7,000	
Food and personal	6,000	
Housing	6,500	
Medical and dental	900	
Clothing	3,000	
Transportation	3,200	
Miscellaneous	2,800	
Total		29,400
Net income		$ 600

   b. Yes. $600

   c. The information probably came from W-2 forms from employer as to income and taxes and from their checkbooks and receipts as to expenses.

2. a.

Moreno Family Balance Sheet
December 31, 1979

Assets			*Liabilities*		
Monetary Assets			Liabilities		
Cash	$ 900		Unpaid bills	$ 700	
Savings	1,500		Installment debt	2,500	
Cash value insurance	2,000		Mortgage	35,000	
Stocks and bonds	7,000		Total		$38,200
Total		$11,400			
Fixed Assets			Net Worth		56,400
Autos	$ 3,700				
Personal assets	4,500				
Home	75,000				
Total		83,200			
Total Assets		$94,600	Liabilities and Net Worth		$94,600

b. $56,400

c. While the balance sheet shows a substantial net worth, their yearly savings are inadequate and do not augur well for future increases in net worth.

3. a. Trina's income statement might be constructed as follows:

Salary	$12,000	
Dividends and interest	146	
Total income		$12,146
Income taxes	$ 1,930	
Social Security	702	
Total taxes		2,632
Remaining for living expenses and investments		$ 9,514
Utilities	$ 416	
Insurance (property)	120	
Rent	2,520	
Food (plus personal)	1,100	
Clothing	620	
Gas and repairs	640	
Auto license	50	
Auto payments	1,560	
Insurance (auto)	240	
Recreation, vacation	820	
Dentist	86	
Insurance (medical)	120	
Fixed assets (stereo)	690	
Other expenses (unidentified cash)	320	
Total living expenses		9,302
Amount remaining for savings (profit)		$ 212

b. If she continues this year as in the past, her profit should improve by as much as $1,040 because she will have no auto payments the last eight months of the year. To the extent repairs on an aging car don't use this money up, she should save it to help buy the next car and reduce her monthly payments needed for that purchase.

c. Additional ideas for saving money include sharing her apartment with a roommate (saving of $1,260); getting an extra part-time job; taking public transportation to work (or carpooling); asking herself if she *really needs* to spend money for some of the kinds of things she did last year; work for a raise, promotion, or new job.

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d. Trina's net worth is as follows:

Assets		
Monetary Assets		
Cash	$ 27	
Checking	345	
Savings	2,108	
Stocks (10 AT&T)	650	
Total		$ 3,130
Fixed Assets		
Auto	$2,100	
Personal property	8,000	
Total		10,100
Total Assets		$13,230

Liabilities		
Liabilities		
Unpaid bills	$ 260	
Auto loan	520	
Total		$ 780
Net Worth		$12,450

e. $3,130 of her $12,450 net worth, or 25 percent, is liquid.

f. She has kept her debts well within her ability to repay them.

CHAPTER 4 BUDGETING

True-False	Completion	Multiple Choice
1. T	1. $40	1. e
2. F	2. mad money	2. c
3. F	3. inflation	3. d
4. T	4. fail-safe, flexible	4. a
5. F	5. disciplined	5. c
6. F		
7. F		
8. T		
9. F		
10. T		

Cases and Problems

1. Rita is paying $84 more than needed for not budgeting.
$107 × 12 = $1,284; $1,284 - $1,200 = $84

2.

Expense	*Budget*	*Actual*	*Plus or Minus*	*Balance Forward*
Auto	$ 90	$ 40	+$50	$140
Food	105	120	- 15	90
Recreation	65	60	+ 5	70
Rent	230	230	0	230
Other	30	35	- 5	25
Total	$520	$485	+$35	$555

3. a. Not necessarily. If they arrived at the current allotment by averaging last year's utilities bills (assuming they lived in Wisconsin last year) and allowed for rate increases, these deficits will even out in the summer and surpluses will accumulate for next winter's bills. Perhaps, however, because of the great cost differences between summer and winter utilities in a place like Wisconsin, they should average these costs separately and carry one figure for April through September and the other for October through March.

b. Kate and Brad are apparently accumulating money for major gift expenses later in the year, probably at the year-end holidays. They apparently avoided major expenses on their car, such as repairs or new tires, during the last two months.

c. I would advise only one change in the budget at this point: take advantage of the surplus in the food category by reducing the allotment by $5 and add $5 to the monthly utilities allotment just in case this part of the budget is set too low.

d.

Expense Category	Budgeted Monthly Average	Revised Monthly Average	March Balance Forward
Housing	$ 290	$ -	$ 290
Utilities	75	80	15
Food	190	185	200
Recreation	90	-	95
Clothing	100	-	75
Auto	100	-	175
Necessities	38	-	43
Savings	75	-	75
Gifts	63	-	143
Mad money	50	-	50
Total	$1,071	$1,071	$1,161

4. a. $100/month for short-term goals; $125/month for new car; $400/month for house; for a total of $625/month

b. Income: $1,757 ($21,080 ÷ 12)

c. Expenses: $1,772

d. Definitely; even then they are $15 a month short.

e. Reduce one or more of their discretionary spending categories, such as recreation, clothing, gifts, mad money, or short-term goals.

f. Forget about the football tickets and the CB radio; take a cheaper vacation; tighten up the budget.

g. Need reductions of $9 a month to offset two recommended increases.

Expense Category	Budget	February Plus or Minus	Recommendation
Housing	$ 253	+ $ 26	OK
Utilities	45	+ 4	Increase budget $3/control
Food	160	- 13	Increase budget $6/control
Necessities	40	+ 2	OK
Medical	10	+ 5	OK
Clothing	70	- 118	Watch; probably OK
Auto	194	+ 90	OK
Recreation	135	- 43	Control/reduce budget
Personal improvement	28	- 15	Watch; probably OK
Savings	625	0	OK/reduce goals?
Fixed assets	22	- 4	OK
Mad money	40	0	OK/reduce budget
Gifts	60	+ 48	OK
Charity	35	+ 10	OK/reduce budget?
Life insurance	35	+ 70	OK
Contingency	20	+ 40	OK
Total	$1,772		

h. Almost everyone finds it easier to spend money today than to budget and hopes the future will take care of itself. Even with the plan, Liz and Henry are having to cut back a little on their monthly budget.

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CHAPTER 5 INSURANCE PRINCIPLES

True-False	Completion	Multiple Choice
1. F	1. investment	1. b
2. T	2. stock	2. d
3. F	3. fortuitous	3. e
4. T	4. average annual cost	4. a
5. F	5. underwriting	5. c
6. T	6. par or participating	6. d
7. T	7. mutual	7. a
8. F	8. closed-end	8. b
9. T	9. an emergency fund	
10. F	10. transferred or insured against	

Cases and Problems

1. Holly and Adam have cash reserves of $2,000. This is the limit to cover all losses plus the deductibles they choose. They should choose:

   For the home: alternative 3 with a deductible of $250. Their average annual loss is $104 ($520/5), which is lower than the deductible and, when added to the premium of $250, gives an annual cost of $354, a savings of $46 over alternative 1 and $86 over alternative 2.

   For the car: alternative 2 with a deductible of $100. Their average annual loss is $440 ($2,200/5). When the deductible of $100 is added to the premium of $330, the cost is $430 which is $10 less than the $440 premium for the nondeductible. Alternative 3 would have an average annual cost of $490 ($290 premium + $200 deductible), which is $50 greater than the no-deductible premium of $440.

   For the personal property: alternative 3 with a deductible of $100. The premium of $17 plus their average annual loss of $24 ($120/5) give an average annual cost of $41, which is $9 less than the $50 premium with no deductible. Their emergency fund of $2,000 is capable of handling the deductibles in all three policies.

2. Jon should retain the risk of collision. His average annual loss is $184, which is $166 less than the $350 premium, and he has an emergency fund adequate to replace the value of the car.

3. If the basic premium is the only difference, Bill and Mary should choose area 2 with a basic premium of $80 ($17,600/220) over area 1 with a basic premium of $90 ($7,200/80).

CHAPTER 6 PROPERTY INSURANCE

True-False	Completion	Multiple Choice
1. T	1. 80	1. c
2. T	2. market	2. c
3. F	3. 15	3. d
4. T	4. articles	4. e
5. F	5. declining	5. e
6. F	6. inventory	6. a
7. T	7. leasehold	7. c
8. F	8. broad	8. a
9. T	9. flood	9. d
10. F	10. 5	10. e

Cases and Problems

1. a. $84,000 (2,000 × $42)
   b. $67,200 ($84,000 × .8)
   c. $8,929 ($60,000/$67,200 × $10,000)
2. a. By figuring the cost and either the market value or the replacement cost of each item
   b. By taking a room-by-room inventory and pictures of her personal belongings
3.

Item	*%*	*$ Coverage*
detached buildings	10	$ 6,000
trees, shrubs, plants	5	3,000
personal property on premises	50	30,000
personal property off premises	5	3,000
additional living expenses	20	12,000

4. a. Paula and Leon ought to buy an HO 3 policy.
   b.

		Rate of Depreciation		*(A) Replacement Cost*	*Total Cost of Depreciation*	*(B) Market Value*	
Item	*Age (years)*	*Annual*	*Total*	*Cost*	*ciation*	*Value*	(A − B)
bed	0	0	0	$500	$ 0	$500	$ 0
bureau	4	7%	28%	500	140	360	140
stereo	3	10	30	600	180	420	180
chairs (2)	10	7	70	100	70	30	70
dinette	3	7	21	300	63	237	63
bookcase	5	10	50	70	35	35	35
						Total Difference	$488

   c. $80,000 (2,000 × $40)
   d. $40,000 ($80,000 × .50)

CHAPTER 7 COMPREHENSIVE LIABILITY AND AUTO INSURANCE

True-False	**Completion**	**Multiple Choice**
1. T	1. negligence	1. d
2. F	2. four	2. c
3. T	3. umbrella	3. b
4. F	4. collision	4. b
5. T	5. 6,500	5. e
6. F	6. 3	6. c
7. F	7. collision	7. e
8. F	8. no-fault	8. c
9. T	9. 50	9. b
10. F	10. auto	10. b

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Cases and Problems

1. $16,400, computed as follows:

Hospital ($200 × 8 days)	$ 1,600
Salary loss	1,800
Golf clubs	300
Sample case	400
Total loss	$ 4,100
× multiplier (pain, etc.)	3
	$12,300
Plus total expenses	4,100
	$16,400

2. Jill should reject collision insurance. Her loss would not exceed $492 (depreciated car value $792 less collision premium savings of $300) and her savings are sufficient to cover her loss. Also, her expected annual loss is $180 less than the premium.

3. a. Jane and Jim are in phase IV of liability exposure.

   b. Yes, their present coverage is inadequate.

   c. Reduce HO liability to $50,000 and add an umbrella for $1 million. The added cost would be about $70 per year less the small premium reduction on the homeowners policy.

4. a. Since added costs of maximum coverage are not proportional to the added benefits and the dangers are great, Judy should choose the maximum coverages. If she has medical insurance and because she could rely on her other coverages for passengers, she could eliminate the medical expense premiums.

   b.

Bodily injury liability	$ 80
Property damage liability	30
Uninsured motorist	10
Total	$120
Less 20% discount	24
Net premium expense	$ 96

CHAPTER 8 HEALTH INSURANCE

True-False	Completion	Multiple Choice
1. T	1. waiting period	1. b
2. F	2. residual	2. b
3. T	3. presumptive disability	3. a
4. T	4. riders	4. c
5. F	5. Medicare	5. a
6. T	6. Workers' compensation	6. d
7. F	7. industrial	7. c
8. T	8. disability	8. b
9. F	9. combination	9. e
10. F	10. prepayment	10. e

Cases and Problems

1.

1. Ann and Peter's annual living expenses			$23,000
2. Adjustments			
Ann's taxes	$3,200		
Insurance premiums	1,300	$ 4,500	
3. Peter's income		15,000	
4. Investment income		560	
5. Social Security		0	
6. Total			20,060
Ann's annual disability needs unadjusted for inflation			$ 2,940

2. The total cost of the medical care is as follows, as well as what each policy would pay.

Procedure	Total Cost	Hospital Expense		Surgical Expense		Major Medical	
Surgery	$1200	$ 0		$750		$1200	
Hospital (6 days @ $125/day)	750	360		0		750	
Hospital extras	1200	1200		0		1200	
		−100	deductible	−50	deductible	$3150	subtotal
						−500	deductible
Total	$3150	$1460		$700		$2650	
						× 80%	
						$2120	

The major medical is the best buy because it covers all medical expenses, not just one or two types of expenses, and it has a higher maximum payout for roughly the same cost as the other two.

3. a. $2,400 or 2/3 of $1,200 × 3 months

   b. $5,400 or 9 months × $1,000 living expenses less $2,400 disability insurance less $1,200 in sick leave

   c. $3,600 or $2,400 from disability insurance and $1,200 from sick leave

4. Tim's average earnings creditable for Social Security purposes are $7,266. Looking at Table 2 in the Social Security addendum, you can see that a disabled worker would receive approximately $428.50 per month if his average annual earnings were $6,600, and $491.70 if his average annual earnings were $7,800.

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CHAPTER 9 LIFE INSURANCE

True-False	Completion	Multiple Choice
1. F	1. protection	1. a
2. T	2. face amount	2. b
3. T	3. premium	3. c
4. F	4. policy period	4. a
5. T	5. savings	5. c
6. F	6. term	6. e
7. T	7. decreasing	7. e
8. F	8. endowment	8. d
9. T	9. cash value	9. a
10. F	10. refund annuity	10. e

Cases and Problems

1. a. Should Mary die now, her policy would pay $20,000.

   b. The annual cost of the policy is the premium less the annual dividend, or $290.

   c. The amount through investment would equal the policy in about 28 1/2 years instead of the 37 years the insurance company feels it needs to provide the same amount. From this you can see how these companies make good profits. Calculations are as follows:

   (1) Divide $17,500 by $290. This gives you the factor to look up in 5% column of Table B. The factor is 60.34.

   (2) This lies between 58.4 and 62.3, which occurs in years 28 and 29. Since 60.3 is midway, this is just about 28 1/2 years.

2. Jim should wait until he has a need for insurance but he would do well to take the premium proposed and invest it now himself if he has the self-discipline to do so.

3. Ted should deduct the dividend from his premium, borrow the cash value as it builds, and reinvest it at 8 percent. The first year value of each alternative is described below.

   a. Pay the premium and leave the $75 dividend on deposit.

Deposit	$ 75
Plus 4% interest	3
Plus cash value buildup	150
Total year-end value	$228

   b. Deduct dividend from premium.

Invest premium savings	$ 75
Return at 8%	6
Plus cash value buildup	150
Total year-end value	$231

c. Deduct dividend from the premium and borrow the cash value.

Invest premium savings	$ 75
Invest borrowed cash value	150
Subtotal	$225
Less interest cost at 6% on $150	− 9
Plus 8% on $225	18
Total year-end value	$234

Note that with the effect of compounding, the difference between each of the alternatives continues to widen over time.

4. The calculations given on the form are self-explanatory except for Sally's annual income:

$5,000 × 8 years = $40,000
$11,000 × 17 years = $187,000
$40,000 + $187,000 = $227,000
$227,000 ÷ 50 = $4,540

NAME(S) Chad and Sally

DATE ____________

EIGHT-STEP PROCEDURE

1 *Funeral, Administrative, and Estate Tax Expenses*		$ 2,200
2 *Debt Resolution* (excluding home mortgage)		$ 2,800
3 *Contingency Fund* (twice your monthly take-home pay)		$ 2,400
4 *College Fund*		$ 28,000
5 *NET ANNUAL LIVING EXPENSES*		
A. Average annual living expenses	$ 12,000	
B. Spouse's average annual income	$ 4,540	
C. Average annual Social Security	$ 4,000	
D. Net annual income needs (A − B − C)	$ 3,460	
E. Number of years in period	50	
F. Average annual investment rate factor (Table 9-1)	21	
G. TOTAL NET INCOME NEEDS (D x F)		$ 72,660
6 *TOTAL MONETARY NEEDS* (1 + 2 + 3 + 4 + 5G)		$ 108,060
7 *TOTAL INVESTMENT ASSETS*		$ 12,500
8 *Your Life Insurance Needs* (6 − 7)		$ 95,560

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CHAPTER 10 FEDERAL INCOME TAXES ON INDIVIDUALS

True-False	Completion	Multiple Choice
1. T	1. gross income	1. d
2. T	2. zero bracket	2. c
3. F	3. 3	3. c
4. F	4. $100	4. d
5. T	5. $500	5. a
6. T	6. 40	6. b
7. F	7. marginal tax	7. b
8. T	8. income averaging	8. e
9. F	9. tax shelters	9. d
10. F	10. CPAs	

Cases and Problems

1. See page 200.
2. See pages 201–202.
   a. No.
   b. Yes. $1,281
   c. Have all of it refunded, or have part refunded and the rest applied toward next year's taxes.

CHAPTER 11 BORROWING AND BANKING

True-False	Completion	Multiple Choice
1. T	1. carrying	1. e
2. F	2. amortization	2. b
3. T	3. cosigner	3. d
4. T	4. 20	4. b
5. F	5. annual percentage rate	5. c
6. F	6. dollar cost of the loan	6. d
7. T	7. the principal amount borrowed	7. c
8. F	8. character	8. b
9. F	9. inflation	9. a
10. F	10. rule of 78	

Cases and Problems

1. a. $240 (20% × $1,200)
   b. $500 ($5,000 net worth − $4,500 debt)
2. The loan rate of 31.6 percent is exorbitant. The effect of inflation and taxes on this rate does not change this opinion as these considerations affect all loan rates.

Schedules A&B—Itemized Deductions AND Interest and Dividend Income

(Form 1040)

Department of the Treasury
Internal Revenue Service

▶ Attach to Form 1040. ▶ See Instructions for Schedules A and B (Form 1040).

1978

Name(s) as shown on Form 1040: Case Problem 1

Your social security number:

Schedule A—Itemized Deductions (Schedule B is on back)

Medical and Dental Expenses (not paid by insurance or otherwise) (See page 15 of Instructions.)

1	One-half (but not more than $150) of insurance premiums you paid for medical care. (Be sure to include in line 10 below.) ▶	50	00
2	Medicine and drugs	180	00
3	Enter 1% of Form 1040, line 31	140	00
4	Subtract line 3 from line 2. If line 3 is more than line 2, enter zero	40	00
5	Balance of insurance premiums for medical care not entered on line 1	50	00
6	Other medical and dental expenses:		
	a Doctors, dentists, nurses, etc.	1,450	00
	b Hospitals		
	c Other (itemize—include hearing aids, dentures, eyeglasses, transportation, etc.) ▶		
7	Total (add lines 4 through 6c)	1,540	00
8	Enter 3% of Form 1040, line 31	420	00
9	Subtract line 8 from line 7. If line 8 is more than line 7, enter zero	1,120	00
10	**Total medical and dental expenses (add lines 1 and 9).** Enter here and on line 33 ▶	1,170	00

Taxes (See page 15 of Instructions.)

11	State and local income	1,900	00
12	Real estate	1,000	00
13	State and local gasoline (see gas tax tables)	70	00
14	General sales (see sales tax tables)	500	00
15	Personal property		
16	Other (itemize) ▶		
17	**Total taxes (add lines 11 through 16).** Enter here and on line 34 ▶	3,470	00

Interest Expense (See page 16 of Instructions.)

18	a Home mortgage	3,500	00
	b Credit and charge cards		
19	Other (itemize) ▶		
20	**Total interest expense (add lines 18a through 19).** Enter here and on line 35 ▶	3,500	00

Contributions (See page 17 of Instructions.)

21	a Cash contributions for which you have receipts, cancelled checks or other written evidence	400	00
	b Other cash contributions (show who you gave to and how much you gave) ▶		
22	Other than cash (see page 17 of instructions for required statement)		
23	Carryover from prior years		
24	**Total contributions (add lines 21a through 23).** Enter here and on line 36 ▶	400	00

Casualty or Theft Loss(es) (See page 17 of Instructions.)

25	Loss before insurance reimbursement		
26	Insurance reimbursement		
27	Subtract line 26 from line 25. If line 26 is more than line 25, enter zero		
28	Enter $100 or amount on line 27, whichever is smaller		
29	**Total casualty or theft loss(es) (subtract line 28 from line 27).** Enter here and on line 37 ▶		

Miscellaneous Deductions (See page 17 of Instructions.)

30	Union dues	150	00
31	Other (itemize) ▶		
32	**Total miscellaneous deductions (add lines 30 and 31).** Enter here and on line 38 ▶	150	00

Summary of Itemized Deductions (See page 18 of Instructions.) **A**

33	Total medical and dental—from line 10	1,170	00
34	Total taxes—from line 17	3,470	00
35	Total interest—from line 20	3,500	00
36	Total contributions—from line 24	400	00
37	Total casualty or theft loss(es)—from line 29		
38	Total miscellaneous—from line 32	150	00
39	**Total deductions (add lines 33 through 38)** ▶	8,690	00
40	If you checked Form 1040, Filing Status box: 2 or 5, enter $3,200 1 or 4, enter $2,200 3, enter $1,600	2,200	00
41	Subtract line 40 from line 39. Enter here and on Form 1040, line 33. (If line 40 is more than line 39, enter zero and see "You Must Itemize Deductions" on page 11 of the Instructions.) ▶	6,490	00

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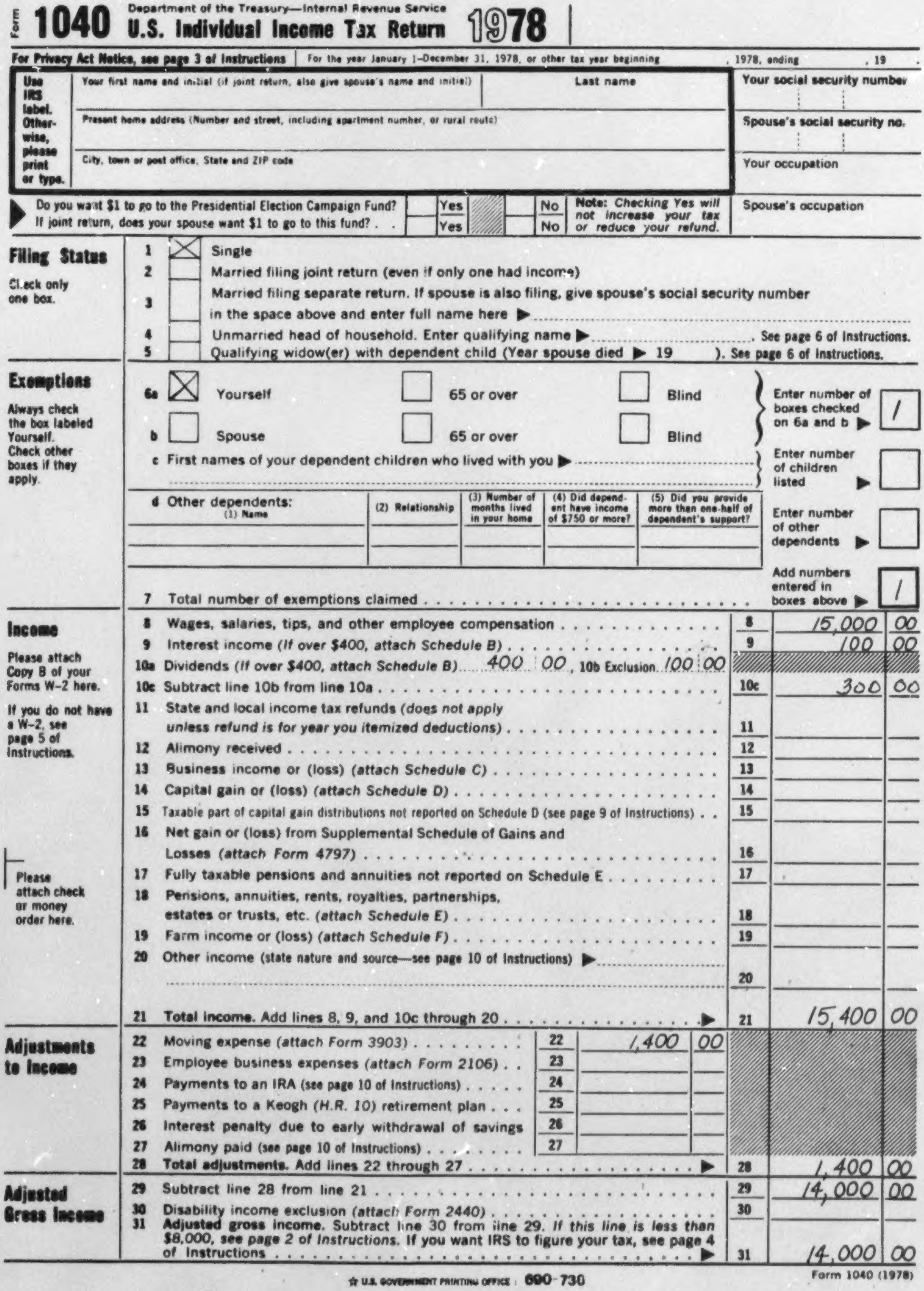

Form **1040** Department of the Treasury—Internal Revenue Service
U.S. Individual Income Tax Return **1978**

For Privacy Act Notice, see page 3 of Instructions | For the year January 1–December 31, 1978, or other tax year beginning , 1978, ending , 19

Use IRS label. Otherwise, please print or type.	Your first name and initial (if joint return, also give spouse's name and initial)	Last name
	Present home address (Number and street, including apartment number, or rural route)	
	City, town or post office, State and ZIP code	

Your social security number

Spouse's social security no.

Your occupation

Spouse's occupation

Do you want $1 to go to the Presidential Election Campaign Fund? ☐ Yes ☐ No
If joint return, does your spouse want $1 to go to this fund? ☐ Yes ☐ No
Note: Checking Yes will not increase your tax or reduce your refund.

Filing Status
Check only one box.

1 ☒ Single
2 ☐ Married filing joint return (even if only one had income)
3 ☐ Married filing separate return. If spouse is also filing, give spouse's social security number in the space above and enter full name here ▶
4 ☐ Unmarried head of household. Enter qualifying name ▶ .... See page 6 of Instructions.
5 ☐ Qualifying widow(er) with dependent child (Year spouse died ▶ 19). See page 6 of Instructions.

Exemptions
Always check the box labeled Yourself. Check other boxes if they apply.

6a ☒ Yourself ☐ 65 or over ☐ Blind
b ☐ Spouse ☐ 65 or over ☐ Blind
Enter number of boxes checked on 6a and b ▶ 1

c First names of your dependent children who lived with you ▶
Enter number of children listed ▶

d Other dependents: (1) Name	(2) Relationship	(3) Number of months lived in your home	(4) Did dependent have income of $750 or more?	(5) Did you provide more than one-half of dependent's support?

Enter number of other dependents ▶

7 Total number of exemptions claimed .... Add numbers entered in boxes above ▶ 1

Income
Please attach Copy B of your Forms W-2 here.
If you do not have a W-2, see page 5 of Instructions.
Please attach check or money order here.

8	Wages, salaries, tips, and other employee compensation	8	15,000 00
9	Interest income (If over $400, attach Schedule B)	9	100 00
10a	Dividends (If over $400, attach Schedule B) 400 00, 10b Exclusion 100 00		
10c	Subtract line 10b from line 10a	10c	300 00
11	State and local income tax refunds (does not apply unless refund is for year you itemized deductions)	11	
12	Alimony received	12	
13	Business income or (loss) (attach Schedule C)	13	
14	Capital gain or (loss) (attach Schedule D)	14	
15	Taxable part of capital gain distributions not reported on Schedule D (see page 9 of Instructions)	15	
16	Net gain or (loss) from Supplemental Schedule of Gains and Losses (attach Form 4797)	16	
17	Fully taxable pensions and annuities not reported on Schedule E	17	
18	Pensions, annuities, rents, royalties, partnerships, estates or trusts, etc. (attach Schedule E)	18	
19	Farm income or (loss) (attach Schedule F)	19	
20	Other income (state nature and source—see page 10 of Instructions) ▶	20	
21	**Total income.** Add lines 8, 9, and 10c through 20 ▶	21	15,400 00

Adjustments to Income

22	Moving expense (attach Form 3903)	22	1,400 00		
23	Employee business expenses (attach Form 2106)	23			
24	Payments to an IRA (see page 10 of Instructions)	24			
25	Payments to a Keogh (H.R. 10) retirement plan	25			
26	Interest penalty due to early withdrawal of savings	26			
27	Alimony paid (see page 10 of Instructions)	27			
28	**Total adjustments.** Add lines 22 through 27 ▶			28	1,400 00

Adjusted Gross Income

29	Subtract line 28 from line 21	29	14,000 00
30	Disability income exclusion (attach Form 2440)	30	
31	**Adjusted gross income.** Subtract line 30 from line 29. If this line is less than $8,000, see page 2 of Instructions. If you want IRS to figure your tax, see page 4 of Instructions ▶	31	14,000 00

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Form 1040 (1978)

Form 1040 (1978) **Page 2**

Tax Computation	32 Amount from line 31				32	14,000	00
	33 If you do not itemize deductions, enter zero If you itemize, complete Schedule A (Form 1040) and enter the amount from Schedule A, line 41				33	6,490	00
	Caution: If you have unearned income and can be claimed as a dependent on your parent's return, check here ▶ ☐ and see page 11 of the Instructions. Also see page 11 of the Instructions if: • *You are married filing a separate return and your spouse itemizes deductions, OR* • *You file Form 4563, OR* • *You are a dual-status alien.*						
	34 Subtract line 33 from line 32. Use the amount on line 34 to find your tax from the Tax Tables, or to figure your tax on Schedule TC, Part I				34	7,510	00
	Use Schedule TC, Part I, and the Tax Rate Schedules ONLY if: • *The amount on line 34 is more than $20,000 ($40,000 if you checked Filing Status Box 2 or 5), OR* • *You have more exemptions than those covered in the Tax Table for your filing status, OR* • *You use any of these forms to figure your tax: Schedule D, Schedule G, or Form 4726.* Otherwise, you MUST use the Tax Tables to find your tax.						
	35 Tax. Enter tax here and check if from ☐ Tax Tables or ☐ Schedule TC				35	719	00
	36 Additional taxes. (See page 11 of Instructions.) Enter total and check if from ☐ Form 4970, ☐ Form 4972, ☐ Form 5544, ☐ Form 5405, or ☐ Section 72(m)(5) penalty tax				36		
	37 **Total.** Add lines 35 and 36 ▶				37	719	00
Credits	38 Credit for contributions to candidates for public office	38					
	39 Credit for the elderly *(attach Schedules R&RP)*	39					
	40 Credit for child and dependent care expenses (attach Form 2441)	40					
	41 Investment credit *(attach Form 3468)*	41					
	42 Foreign tax credit *(attach Form 1116)*	42					
	43 Work Incentive (WIN) Credit *(attach Form 4874)*	43					
	44 New jobs credit *(attach Form 5884)*	44					
	45 Residential energy credits (see page 12 of Instructions, attach Form 5695)	45					
	46 **Total credits.** Add lines 38 through 45				46		
	47 **Balance.** Subtract line 46 from line 37 and enter difference (but not less than zero) ▶				47	719	00
Other Taxes	48 Self-employment tax *(attach Schedule SE)*				48		
	49 Minimum tax. Check here ▶ ☐ and attach Form 4625				49		
	50 Tax from recomputing prior-year investment credit *(attach Form 4255)*				50		
	51 Social security (FICA) tax on tip income not reported to employer *(attach Form 4137)*				51		
	52 Uncollected employee FICA and RRTA tax on tips *(from Form W–2)*				52		
	53 Tax on an IRA *(attach Form 5329)*				53		
	54 **Total tax.** Add lines 47 through 53 ▶				54	719	00
Payments Attach Forms W–2, W–2G, and W–2P to front.	55 Total Federal income tax withheld	55	2,000	00			
	56 1978 estimated tax payments and credit from 1977 return	56					
	57 Earned income credit. If line 31 is under $8,000, see page 2 of Instructions. If eligible, enter child's name ▶	57					
	58 Amount paid with Form 4868	58					
	59 Excess FICA and RRTA tax withheld (two or more employers)	59					
	60 Credit for Federal tax on special fuels and oils (attach Form 4136)	60					
	61 Regulated Investment Company credit *(attach Form 2439)*	61					
	62 **Total.** Add lines 55 through 61 ▶				62	2,000	00
Refund or Due	63 If line 62 is larger than line 54, enter amount **OVERPAID** ▶				63	1,281	00
	64 Amount of line 63 to be **REFUNDED TO YOU** ▶				64	1,281	00
	65 Amount of line 63 to be credited on 1979 estimated tax ▶	65					
	66 If line 54 is larger than line 62, enter **BALANCE DUE.** Attach check or money order for full amount payable to "Internal Revenue Service." Write your social security number on check or money order ▶ (Check ▶ ☐ if Form 2210 (2210F) is attached. See page 14 of instructions.) ▶ $				66		

Please Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

▶ Your signature Date

▶ Spouse's signature (if filing jointly, BOTH must sign even if only one had income)

Paid Preparer's Information	Preparer's signature ▶	Preparer's social security no.	Check if self-employed ▶ ☐
	Firm's name (or yours, if self-employed), address and ZIP code ▶	E.I. No. ▶	
		Date ▶	

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3. a. $\frac{15¢}{\$10} = 1.5\% \times 12\text{ (months)} = 18\%/\text{year}$

   b. low to medium cost

   c. $15

   d. The loan was lower risk than average because of the financial strength of the lender or the loan is secured by some collateral.

CHAPTER 12 BORROWING: CONSUMER CREDIT

True-False	Completion	Multiple Choice
1. T	1. installment	1. c
2. F	2. adjusted	2. b
3. F	3. 30-day	3. c
4. T	4. revolving	4. e
5. T	5. installment purchase agreement	5. c
6. F	6. wage assignment	6. c
7. T	7. cognovit	7. d
8. T	8. add-on	8. a
9. T	9. financing lease	
10. F	10. prepayment	

Cases and Problems

1. You can refuse payment on the Visa card until the local store or the bank sees that the set is fixed.
2. The store must give you the name and address of the credit bureau that gave them the information causing them to reject your application. The credit bureau must:
   a. delete erroneous or inaccurate information
   b. tell you the nature of all the information in your file
   c. include your explanation of the disputed facts

CHAPTER 13 AUTOMOBILES AND MAJOR APPLIANCES

True-False	Completion	Multiple Choice
1. T	1. standard (or full)	1. c
2. F	2. *Kelley's Blue Book*	2. a
3. F	3. mo-peds	3. e
4. T	4. sticker	4. c
5. T	5. manufacturer's representative	5. d
6. F		
7. T		
8. F		

Cases and Problems

1. Since Kevin is single with a fairly good salary, he has no present worries. If he is concerned about the future and wants to cut his transportation costs, he could trade in his car for a subcompact or mo-ped, use mass transit, or move closer to his work.
2. Jane should offer $4,600 for her dream car since this is the sum of the dealer's cost and minimum markup. She would probably do better to sell the car herself since the trade-in offer is substantially lower than the book value.
3. If Tom and Mary rent an unfurnished apartment without built-in appliances, they may save substantially on rent. They could buy second-hand appliances and furniture to resell if they move. If they buy any new furniture, they should buy and pay for quality because it will be with them for a long time.

CHAPTER 14 HOUSING

True-False	Completion	Multiple Choice
1. T	1 25	1. c
2. T	2. 2½	2. b
3. F	3. deed	3. b
4. F	4. title abstract	4. d
5. T	5. variable rate mortgage	5. c
6. F	6. flexible payment	6. d
7. F	7. FHA (Federal Housing Administration)	7. d
8. T	8. VA (Veterans Administration)	8. c
9. T	9. 1	9. d
	10. 2	

Cases and Problems

1. One alternative is to look at a less expensive home. Another is to reassess your finances to see if you can make a $20,000 down payment. Finally, you could attempt to find a lender who will offer you a second mortgage.

2.	Down payment	$15,000
	1st mortgage points (24,000 × 1% = 240 × 2 =)	480
	2nd mortgage points (5,000 × 1% = 50 × 4 =)	200
	Title insurance fees	230
	Escrow fees	130
	Attorney's fees	250
	Total	$16,290

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3. Year	1	2	3	4	5
Mutual fund value	$5,000	$4,062[1]	$3,117[1]	$2,164[1]	$1,203[1]
Appreciation (10%)	500	406	311	216	120
Tax cost @ 12.5%[2]	-63	-51	-39	-27	-15
Net gain	437	355	272	189	105
Net value	5,437	4,417	3,389	2,353	1,308
Loan value	5,000	4,000	3,000	2,000	1,000
Principal payment	1,000	1,000	1,000	1,000	1,000
Interest cost @ 10%	500	400	300	200	100
Tax savings[3]	-125	-100	-75	-50	-25
Net cost	375	300	225	150	75
Net reduction	1,375	1,300	1,225	1,150	1,075
Residual fund value[4]	4,062	3,117	2,164	1,203	233

[1] Corresponds with residual fund value for previous year.

[2] One-half of ordinary tax rate for long-term capital gain.

[3] 10% interest cost assumed deducted as itemized deduction against AGI to create tax savings of 25% of interest cost.

[4] The difference betwen the net value and the net reduction in mutual fund value.

If your mutual fund does indeed appreciate 10 percent a year in value, you will be $233 ahead by not converting your $5,000 mutual fund into the additional down payment. However, if the appreciation is less than this or does not occur at all, the benefit of such a strategy is eliminated.

CHAPTER 15 INVESTMENT PRINCIPLES

True-False	Completion	Multiple Choice
1. T	1. Risk	1. d
2. F	2. business	2. c
3. F	3. Interest rate	3. c
4. T	4. diversification	4. c
5. T	5. rent	5. b
6. F	6. compound	6. b
7. T	7. liquid	7. b
8. F	8. compound interest	8. d
9. T	9. 11	9. b
	10. income statement	10. a

Cases and Problems

1. There are 12 30-year periods in the 360 years of the problem. Using compound interest Table A, multiply 5.7 (the 30-year factor for 6%) times itself 12 times, and the result times the $24. The answer is about $160,000,000,000!

2. No matter how closely you watch any "basket," something outside your control can go wrong. Probably no rational person would want to live with the risk that the portfolio could be 100 percent wiped out simply because some terrible, unexpected inflation, deflation, interest rate, or business risk ruined the one investment in the portfolio.

3. Cousin Timid's plan:

Goal	Amount Needed	Years	Inflation Factor	Adjusted Amount	Factor Lump Sum	Factor Annual Investment	Lump Sum Needed
							$20,000
1. Truck—5%	$4,000	4	1.2	$4,800	1.2[a]		4,000
							16,000
2. Tour Asia—5%	5,000	7	1.4	7,000	1.6[b]		4,375
							11,625
3. Tour Europe—5%	4,000	10	1.6	6,400	2.6[c]		2,460
							9,165
4. Cabin—6%	15,000	15	2.4	36,000	4.2[c]		8,571
							594

[a] Corporate bonds @ 5%

[b] Mutual funds @ 7%

[c] Real estate syndicate @ 10%

CHAPTER 16 FIXED DOLLAR INVESTMENTS

True-False	Completion	Multiple Choice
1. T	1. credit unions	1. e
2. F	2. NOW (negotiable order of withdrawal)	2. d
3. T	3. Series HH	3. e
4. F	4. $40,000	4. a
5. F	5. bonus	5. d
6. T	6. rising-interest-rate	6. c
7. T	7. nominal	7. a
8. T	8. inflation	8. b
9. T	9. mutual savings, money market mutual	9. d
10. T		10. d

Cases and Problems

1. a. Under FIFO, the first deposit made was the first withdrawn so there was nothing on deposit for the whole quarter.

   b. $1.25 computed on a balance of $100 for the full quarter.

2. Tony is losing 1 percent a year on his deposits.
   10 percent - 40 percent of 10 percent - 7 percent = -1 percent

3. a. $4,800

   b. $6,600 but is subject to lower rate if withdrawn before the four years are up.

4. Tom should shift his deposits when the difference in rates becomes appreciable. Such shifts would probably not occur more than once or twice a year.

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CHAPTER 17 STOCKS AND BONDS

True-False	Completion	Multiple Choice
1. T	1. $19,000	1. d
2. F	2. 9; 15	2. c
3. F	3. price	3. b
4. F	4. growth	4. a
5. T	5. mature growth	5. c
6. F	6. cumulative	6. d
7. F	7. decrease	7. e
8. T	8. municipal	8. c
9. T	9. convertible	9. e
	10. income	10. d

Cases and Problems

1. 10.15% calculated as follows:

   $75 ÷ $920 = 8.15%

   $1,000 ÷ $920 = 1.087

   Table A value for 4 years, 1.08 = 2%

   8.15% + 2% = 10.15%

2. a. cyclical; $5; 8; 8%

   b. second-tier growth; $40,000,000; $44

   c. 60,000,000; 20; 1%

   d. $40; $2.40; $4

   e. $1; 30; 0%

3. $2,898 profit including all dividends, interest, and capital gains. A 6 percent savings account (compounded annually) would have given her $2,472, only a bit less. The after-tax return on the stocks and bonds is as follows:

Dividends	$ 958	
Less taxes at 40%	383	
Net dividends		$ 575
Interest is tax free		840
Capital gains	$1,100	
One-half taxable	550	
Taxes at 40%	220	
Net capital gains		880
Net after tax		$2,295

The after-tax return on a 6 percent savings account would be:

Interest	$2,472
Less tax at 40%	989
Net after tax	$1,483

Thus, your Aunt Susan would be happy with the results since you gave her a significantly higher return after tax than she could have obtained in a management-free savings account; it was also higher than she should have expected since the Dow Jones averages showed she should have expected no capital gains from the stock market. If she complained only about the loss in stock B, you should be upset with her. After all, the total return was good, and *nobody* can expect to be right much more than half the time! No one is perfect in the stock market.

4. a. Current yield on the bond is 8.5 percent ($75 ÷ $880). The yield to maturity is approximately 9.5 percent (8.5% + 1%).

$$\frac{\$1{,}000}{\$\ 880} = 1.136\text{, or about } 1\% \text{ from compound interest Table A}$$

b. The current yield on the common stock is zero.

c. The conversion value of the bond is equal to $875 of stock, so the bond is selling at only a $5 premium over its conversion value.

d. The convertible bond appears to be the better buy because you will get the interest income even if the stock does not go up in price. This apparently obvious decision is usually not so clear-cut, however, with regard to convertible securities.

CHAPTER 18 BUYING AND SELLING STOCKS AND BONDS

True-False	Completion	Multiple Choice
1. T	1. primary	1. a
2. F	2. Securities Exchange Commission (SEC)	2. b
3. T	3. listing	3. e
4. T	4. New York Stock Exchange (NYSE)	4. e
5. F	5. street name	5. e
6. F	6. dollar cost averaging	6. d
7. T	7. Selling short	7. c
8. F	8. buying on margin	8. d
9. F	9. 500	9. e
10. F	10. market	10. e

Cases and Problems

1. a. 1.67% loss on her investment. Proceeds from the sale were $4,695 ($4,787.50 - $92.50). Costs were $4,600 ($4,512.50 + $87.50). Gain on the sale was $95 ($4,695 - $4,600). Add to this the dividends of $80 for a total gain on the transaction of $175. The interest on the borrowed $2,100 ($4,600 - $2,500) at 12% is $252. Amy lost $77 ($252 - $175) on her investment of $4,600 which is a percentage loss of 1.67% ($77 ÷ $4,600).

   b. 3.8% ($175/$4,600)

2. a. $1,500 ($35 - $20 = $15/share; $15 × 100 shares)

   b. $500 ($40 - $35 = $5/share; $5 × 100 shares)

   c. The AB Medical Technology Co., aware of the problems, might have corrected them quickly or made a new discovery of equal importance.

   d. Beth is not a trained trader and has not sufficient expertise to use short-term trader techniques.

3. No, the value of the asset on Paul's balance sheet is the same, whether or not he sells it. He would lose $2,000 before taxes on his $4,500 investment. A $2,000 long-term capital loss results in a minus $1,000 taxable income; times his 30 percent tax bracket results in a $300 savings in income taxes; so his after-tax loss is $1,700. Sell the Maudlin Gardens to buy the Parke Place, and have $300 extra from tax savings to invest elsewhere.

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4. Not buy these:

S.S. Kresge: Carter Hawley Hale is a better distribution stock because of the low beta and high dividend yield.

Reading & Bates: Beta too high; other two energy stocks fill this category well.

C.R. Bard: Beta too high; Syntex is better. Although Syntex dividend yield is low, she needs "health" and "second-tier growth" representation in at least one stock.

Digital Equipment: No income yield.

Memorex: Way too risky a beta; no income yield.

Note: The next stock she should look for is a financial stock. She has none.

CHAPTER 19 MUTUAL FUNDS

True-False	Completion	Multiple Choice
1. F	1. $1	1. c
2. T	2. closed-end	2. b
3. F	3. net asset value	3. d
4. T	4. unit trusts	4. d
5. T	5. dual	5. c
6. F	6. automatic reinvestment	6. d
7. T	7. closed-end	7. b
8. F	8. balanced	8. a
9. F	9. prospectus	9. d
10. T	10. variable annuity	

Cases and Problems

1. a. 986.19 ($10,000 ÷ $10.14)

   b. $28,347 (2,010.45 × $14.10)

   c. About 10½ or 11% ($28,347 ÷ $10,000 = 2.8347) (found in Table A 10-year column)

   d. This was a better than average return for that period.

   e. $2,660 ($95 × 28)

2. $15 net asset value per share. If it had an 8% load added, the purchase price would be $16.20 per share.

3. a. 8% ($12,800 ÷ $4,000 = 3.2, Table A factor for 8% return on 15-year investment)

   b. No, the high 7½–7¼% rates on long-term certificates have been available for only the latter part of Irene's 15-year investment period. In any case, the capital gains tax advantages would have put her ahead of the fully taxable return on a savings account.

   c. To be safe, Irene should redeem $8,000 worth of her mutual fund and put the money in a savings account. Irene would hate to have to sell shares later if a bear market had severely reduced the value of her investment.

4. Fund D, the dual fund capital shares. If the market goes up, these shares will almost surely appreciate at a faster rate than the market. Fund C is also a possible choice although the $350,000,000 size of the fund makes superior future results uncertain. Fund B, though small and flexible, has a less aggressive objective than funds C or D. Funds A and E are far too conservative for Henry's needs.

CHAPTER 20 REAL ESTATE

True-False	Completion	Multiple Choice
1. F	1. second mortgage	1. b
2. F	2. loan broker	2. d
3. T	3. request for notice of default and sale	3. a
4. T	4. acceleration	4. a
5. F	5. REIT	5. b
6. F	6. real estate investment company	6. e
7. T	7. real estate investment syndicate	7. a
8. T	8. cash flow distribution	8. e
9. T	9. gross income multiplier	9. a
10. F	10. capitalization rate	10. b

Cases and Problems

1. a. Tony's annual cash flow was $404 computed as follows:

Gross rental income		$8,400
Less operating expenses (Costs)		
Insurance	$ 260	
Maintenance and repairs	500	
Property taxes	2,500	
Total		3,260
Net operating income		$5,140
Less mortgage payment		4,736
Net cash inflow		$ 404

b. $71 tax benefits computed as follows:

Net operating income		$5,140
Less interest on mortgage ($40,320 × 10%)	$4,032	
Depreciation[1]	1,344	
Total		5,376
Taxable income		($ 236)
Taxes saved at 30% bracket		$ 71

c. 11.7% computed as follows:

Net cash income	$ 404
Tax savings	71
Equity buildup ($4,736 − $4,032)	704
Total	$1,179

$1,179/$10,080 = 11.7%

---

[1] .20 × $50,400 = $10,080 value of land
$50,400 − $10,080 = $40,320 value of duplex
$40,320 ÷ 30 years = $1,344 depreciation

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2. The chart illustrates most of the commonly found conflicts of interest (except for the case where the seller is another limited partnership, also controlled by the general partner). In this chart, we see the following:

   a. LMN General Partner is supposed to be negotiating to buy property on behalf of the limited partners, but is really negotiating with itself because the developer/seller (LMN Development Corp.) is controlled by the same people (LMN Realty Corp. and Lemon, Mozarella, and Noble) who control the general partner. There is a tremendous incentive to overprice the property.

   b. Independent Insurance Brokerage Corp. of California may sell high-priced insurance policies to cover the partnership's properties in order to increase the profits to LMN Realty Corp., which also owns the LMN General Partner.

   c. Similarly, the mortgage loans may have high placement fees, or "points," to Universal Mortgage Bankers, Inc., which is owned by the attorneys who also own LMN Realty Corp.

   d. If there is a legal dispute (perhaps as to whether or not some construction defect is the fault of LMN Development Corp.), who will the attorneys represent? LMN Realty Corp. and its interests, of which they are part owners, or the limited partners of the partnership?

   The wholly-owned LMN Property Management firm is necessary to be able to maximize the profit potential of the properties. Of course, the property management fees charged to the partnership must be reasonable and customary for this service. There are no circumstances under which you should invest in a partnership in which the general partners have such incentives to profit for themselves, at the potential detriment to the limited partners.

3. a. She is actually losing $3,158 on the deal.

Income	
Scheduled gross income ($1,400 × 12 months)	$16,800
Vacancy allowance of 3%	- 504
Forfeited cleaning deposits	300
Collected gross income	$16,596
Expenses	
Property management fee (5% × $16,596)	$ 830
Property taxes	3,000
Water, garbage, gardening ($180 × 12 months)	2,160
Insurance	400
Normal maintenance ($200 × 4 units)	800
Major repair reserve ($50 × 4 units × 12 months)	2,400
Total operating expenses	$ 9,590
Net operating income	$ 7,006
Mortgage payments ($847 × 12 months)	- 10,164
Net cash income (outflow)	($ 3,158)

   b. Her negative cash flow is equal to 10.5 percent of her cash investment.

Purchase price (100 × $1,400)	$140,000
Mortgage	110,000
Down payment	$ 30,000

   $3,158 ÷ $30,000 = 10.5%

   c. The property must appreciate by 2.26 percent next year for her to break even.

   $3,158 ÷ $140,000 = 2.26%
   $140,000 × 2.26% = $3,164 appreciation to cover $3,158 cash outflow

CHAPTER 21 RETIREMENT

True-False	Completion	Multiple Choice
1. F	1. Keogh Act	1. b
2. T	2. straight life annuity	2. d
3. F	3. deferred profit sharing	3. c
4. T	4. individual retirement account (IRA)	4. e
5. T	5. Keogh, IRA	5. d
6. F	6. vesting	6. b
7. T	7. 15	7. d
8. F	8. Employees Retirement Income Security Act	8. c
9. T	9. Social Security	9. c
	10. 25	

Cases and Problems

1.

	Question a	Question b	Question c
Total annual living expenses	$ 11,000	$ 11,000	$ 11,000
Number of retirement years	15	20	20
Total living expenses during retirement	$161,000	$220,000	$220,000
One time costs	-	-	-
Total funds needed at retirement	$161,000	$220,000	$220,000
Years to retirement	15	15	15
Inflation factor	1.56	1.81	2.19
Total inflated living expenses at retirement	$251,160	$398,200	$481,800

2.

	15 years 3%	20 years 3%	20 years 4%
Annual income from Social Security	$ 10,800	$ 10,800	$ 10,800
($450 × 12 × 2)	(× 1.56)	(× 1.81)	(× 2.19)
Inflated annual Social Security income	16,848	19,548	23,652
Annual pension benefits	8,400	8,400	8,400
Total annual Social Security and pension income	$ 25,248	$ 27,948	$ 32,052
Expected years of retirement	15	20	20
Total retirement income	$378,720	$558,960	$641,040

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CHAPTER 22 TRANSFERRING YOUR ESTATE

True-False	Completion	Multiple Choice
1. F	1. community property	1. d
2. F	2. will	2. c
3. T	3. executor	3. a
4. T	4. conditional survival	4. d
5. F	5. remaindermen	5. e
6. T	6. probate	6. b
7. F	7. testamentary	7. a
8. T	8. irrevocable	8. a
9. F	9. intestate	9. e
10. T	10. marital deduction	10. c

Cases and Problems

1. a. $346,000 computed as follows:

Gross estate		$413,000
Deductions:		
Home mortgage	$30,000	
Debts	7,000	
Funeral expenses	3,000	
Executor's expenses	18,000	
Charitable donations	9,000	
Total deductions		67,000
Taxable estate		$346,000

b. $65,580 computed as follows:

Taxable estate		$346,000
Add post-1976 taxable gifts		29,000[1]
Total		$375,000
Tentative tax (Table 22-1)		$113,300[2]
Less taxes paid or payable on		
1978 gift	$3,800	
1979 gift	1,620[3]	
Taxes covered by credits for those periods		
Gross estate tax		$113,300
Less unified credit		42,500
Estate tax		$ 70,800

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[1] $120,000 - $100,000 marital = $20,000 in 1978 plus $15,000 - $6,000 annual exclusion = $9,000. $20,000 + $9,000 = $29,000.

[2] $70,800 on $250,000 plus $42,500 (.34 × $125,000)

[3] $9,000 × 18% = $1,620

2. All of the $100,000 given in 1977 is covered by the marital deduction. Because the gifts are treated as being cumulative, $100,000 of the 1979 gift is not covered and only 50 percent of the remaining $20,000 is covered.

3. Gross estate:

Savings	$ 4,000	
Home	70,000	
Stocks	25,000	
Personal property	15,000	
Life insurance proceeds	50,000	
Total		$164,000
Ordinary and charitable deductions		
Charitable contribution	$ 5,000	
Funeral expenses	1,000	
Home mortgage	15,000	
Executor's expenses	3,000	
Total		24,000
Taxable estate		$140,000

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